Prefatory Note

The attached document represents the most complete and accurate version available based on original files from the FOMC Secretariat at the Board of Governors of the Federal Reserve System.

Please note that some material may have been redacted from this document if that material was received on a confidential basis. Redacted material is indicated by occasional gaps in the text or by gray boxes around non-text content. All redacted passages are exempt from disclosure under applicable provisions of the Freedom of Information Act.

Content last modified 02/09/2012.

Class II FOMC - Restricted (FR)

Part 1

September 13, 2006

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Summary and Outlook

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

Class II FOMC - Restricted (FR)

September 13, 2006

Summary and Outlook

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

Domestic Developments

As we expected, real GDP decelerated in the second quarter to an annual rate of just under 3 percent. While economic activity appears to have slowed further in the current quarter, a number of developments in recent weeks—including significantly lower energy prices, sizable upward revisions to the level of labor income, and generally favorable labor market conditions—would support a continued moderate expansion over the near term. However, real estate markets have weakened more than we had anticipated at midyear, leading us to project a longer and more-pronounced contraction in residential construction than we had previously assumed. On balance, we now expect that real GDP will rise at an annual rate of 1¾ percent in the second half of this year—0.4 percentage point slower than in the August forecast.

Our longer-run forecast for real activity, which now includes a projection for 2008, is characterized by the same broad patterns that were outlined in recent Greenbooks: Real GDP is projected to increase about 2 percent in 2007 and about 2½ percent in 2008. The lagged effects of tighter monetary policy, together with waning stimulus from fiscal policy and household wealth, restrain the rise in real GDP in 2007 and 2008, even as the effects of the downturn in residential construction fade. Taken together, these forces open a small gap in resource utilization over 2007 that persists in 2008 as the rate of increase in real GDP gradually returns to the potential rate of increase. Note that we have lowered our forecast of the increase in potential real GDP by 0.2 percentage point, to 2.7 percent, in 2006 and 2007 and show it moving down to 2.5 percent in 2008.

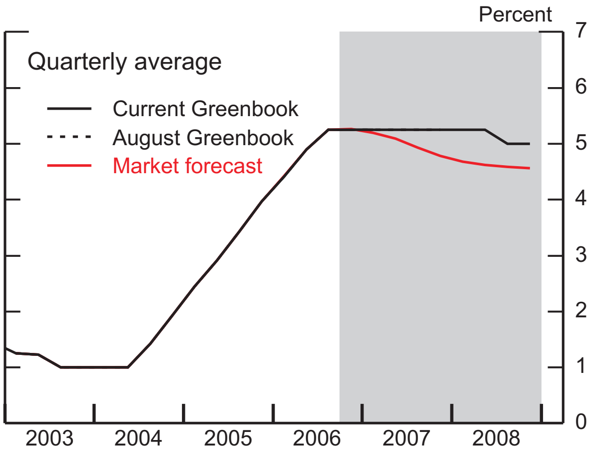
Regarding inflation, the near-term drop in energy prices is expected to be partially reversed next year, altering the pattern of our projection for top-line inflation; the projected increase in the PCE price index has been lowered this year to 2¼ percent and boosted in 2007 to 2½ percent. At the same time, our projection for core inflation is, on balance, little changed, as greater upward pressure from labor costs is offset by less pressure from energy costs. We continue to expect a gradual easing of core inflation, which is perhaps more visible in this forecast with the addition of 2008. By then, with slack in resource utilization remaining and the effects of higher energy and commodity costs having abated, the core PCE price index is projected to show an increase of 2.1 percent—down from 2.4 percent in 2006 and 2.3 percent in 2007.

Key Background Factors

Our economic projections are conditioned on the assumption that the federal funds rate remains at 5¼ percent through mid-2008 and is then lowered to 5 percent. In contrast, Class II FOMC -- Restricted (FR)

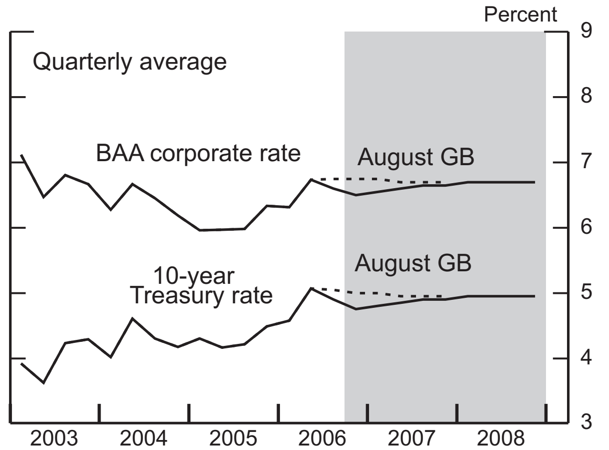
Key Background Factors Underlying the Baseline Staff Projection

Federal Funds Rate

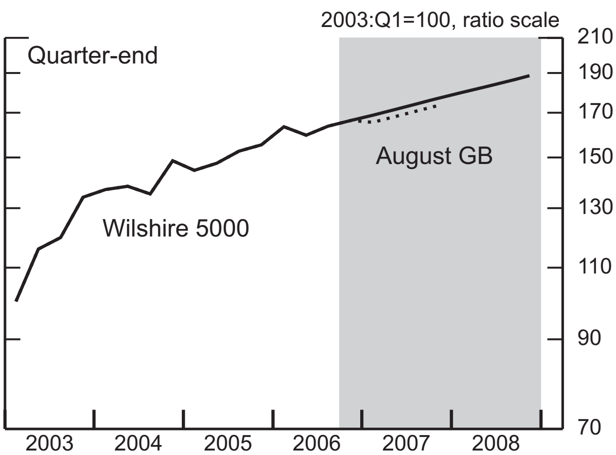


Note. The assumed federal funds rate is unchanged from the August Greenbook.

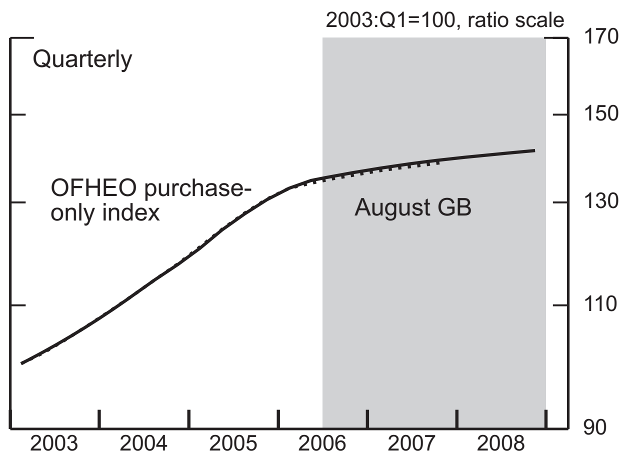
Long-Term Interest Rates



Equity Prices

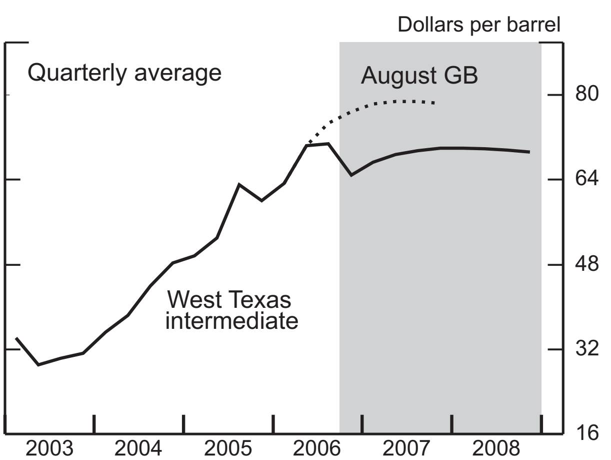


House Prices

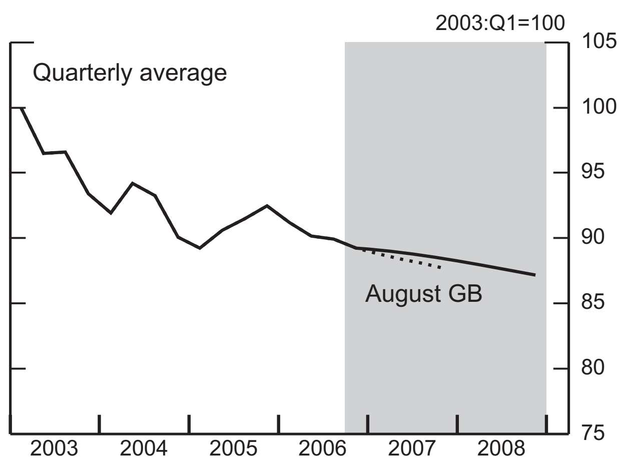


Note. The projection period begins in 2006:Q3.

Crude Oil Prices



Broad Real Dollar



Note. In each panel, shading represents the projection period.

the market expects a more-pronounced easing to begin early next year, with the federal funds rate dropping to about 4½ percent by the end of 2008; that level is roughly ¼ percentage point below the one that investors expected when we closed the August Greenbook. Since then, in light of the revision in the market's outlook for policy, rates on longer-term securities have drifted lower. However, we assume that rates will begin to reverse next year when market participants recognize that the federal funds rate will need to remain higher to induce a moderate decline in inflation; by 2008, longer-term rates should be back to the levels that prevailed in the middle of this year.

Broad equity indexes have moved up since the August Greenbook largely on the favorable news about energy prices and core inflation. As a result, share prices are anticipated to be about 2 percent higher at the end of this quarter than we assumed in the August Greenbook. We continue to assume that, thereafter, equity prices will increase 6½ percent per year, which would roughly maintain risk-adjusted parity with the rate of return on Treasury securities.

The incoming information on prices of residential real estate through the second quarter was close to our expectations. House prices, as measured by the OFHEO purchase-only index, increased at an annual rate of around 5 percent in the second quarter after having risen at a rate of nearly 8 percent in the first quarter. As in previous Greenbooks, we are assuming that this index of house prices will decelerate further, rising at a rate of just under 3 percent in the second half of this year, 2 percent in 2007, and 1½ percent in 2008.

The outlook for fiscal policy has changed little since the August Greenbook. We project that real federal outlays will increase 2 percent over the four quarters of 2007, with the entire rise occurring in real defense purchases; real outlays in both the defense and the nondefense categories are projected to be unchanged in 2008. We continue to assume that the key expiring provisions of the tax law, such as the research and experimentation credit and alternative minimum tax relief, will be extended through 2008. In all, federal fiscal policy is expected to provide an impetus to the change in real GDP of 0.4 percent this year and 0.3 percent in 2007 and then to be neutral in 2008. Given our fiscal policy assumptions, the federal unified budget deficit is anticipated to be $266 billion in fiscal 2006 and then to widen to $308 billion by fiscal 2008 as the subdued pace of economic activity slows the rise in revenues.

The trade-weighted value of the dollar has moved little since the time of the August Greenbook; we continue to assume that it will depreciate modestly over the forecast period. We anticipate that, after having increased at an annual rate of 4¼ percent in the first half of this year, foreign real GDP will rise at a still-solid rate of 3¼ percent per year from the second half of this year through the end of 2008.

In world oil markets, concerns about possible disruptions to supplies have eased noticeably in recent weeks. As a result, the spot price of West Texas intermediate (WTI) crude oil has dropped back to around $64 per barrel—more than $11 lower than it was at the time of the August forecast. Prices in futures markets now suggest that the WTI price will average $65 per barrel in the fourth quarter. However, over the longer run, the price of crude oil is expected to firm because the list of geopolitical risks to oil supplies remains long, spare capacity is lean, and world demand appears likely to continue to expand at a moderate rate. Accordingly, we anticipate that the WTI price will be about $70 per barrel at the end of 2007—$8.50 per barrel lower than we assumed in the August Greenbook—and to remain near that level through 2008.

Recent Developments and the Near-Term Outlook

We now estimate that real GDP increased at an annual rate of 2.8 percent in the second quarter, with the pattern of real activity across the major sectors much as we anticipated in the August Greenbook. Consumer spending rose moderately, nonresidential construction strengthened, and business inventory investment stepped up; but business outlays for equipment and software leveled off after a first-quarter surge, and outlays for residential construction fell steeply.

The BEA revised up significantly its previously published estimate of wage and salary income for the first quarter after incorporating newly available information from unemployment insurance tax records; for the second quarter, the BEA extrapolated the change in income from that elevated level. As a result, the current Greenbook projection begins with a markedly higher level of disposable income—and, thus, a higher saving rate—than shown in the August forecast. We believe that part of the revision resulted from a spurt in exercises of stock options and perhaps other one-time nonwage payments. Accordingly, we have offset about one-half of the first-quarter revision in income in our forecast for the third quarter. Also, we have adjusted down other components of income—particularly proprietors' income—in response to the estimates of personal income for July. Despite these offsets and adjustments, the level of disposable income in this forecast is noticeably higher in the near term than it was in the August Greenbook. In addition, the projection for real income has been boosted further in the near term by lower consumer energy prices. All in all, we now expect that real disposable personal

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

Measure	2006:Q2		2006:Q3	
	Aug. GB	Sept. GB	Aug. GB	Sept. GB
Real GDP	**3.0**	**2.8**	**2.2**	**1.8**
Private domestic final purchases	1.9	1.8	2.5	2.1
Personal consumption expenditures	2.5	2.6	3.2	3.1
Residential investment	-9.0	-10.9	-16.4	-20.6
Business fixed investment	4.9	4.4	9.7	9.5
Government outlays for consumption and investment	1.6	.9	2.1	2.7
	Contribution to growth (percentage points)			
Inventory investment	.7	.7	-.7	-.5
Net exports	.3	.4	.3	-.0

income will increase 3½ percent in 2006—1 percentage point faster than in our previous projection.

As noted, we have sharpened the deceleration in real activity in the second half of this year to incorporate a greater contraction in residential construction than we previously forecast; we now have also included larger scheduled cutbacks in motor vehicle assemblies. In contrast, we continue to project moderate gains in consumer and business spending.

The recent data on employment and unemployment have been in line with our expectations that labor market conditions would remain relatively stable in the near term. Private nonfarm payrolls increased 111,000 in August, about the same pace as in the preceding two months. The unemployment rate continued to hover around 4¾ percent, and the labor force participation rate remained at 66.2 percent—slightly above our current estimate of its underlying trend. The inflow of new claims for unemployment insurance was roughly stable from late July through early September. If, as we are projecting, hiring moderates somewhat further in coming months as real activity continues to slow, we would also expect claims to move up and the unemployment rate to edge higher, to 4.8 percent, by year-end.

Manufacturing production appears to have been little changed in August, but we still expect that it will increase at an annual rate of 4¾ percent this quarter before decelerating to a 2¾ percent rate in the fourth quarter. Although planned reductions in motor vehicle assemblies contribute to the anticipated deceleration, smaller gains in factory production are projected to be fairly widespread outside high-technology industries.

Consumer spending appeared to be continuing to rise at a moderate pace at the beginning of the third quarter. Real personal consumption expenditures, excluding motor vehicles, rose 0.4 percent in July. Sales of new light vehicles were at an average annual rate of 16½ million units in July and August—matching the average pace of the first half. The upward revision to the level of income during the first half of 2006 brought income more in line with the level of overall consumer spending during that period; previously our models had been surprised by the strength of spending in the first half of the year. The actual and projected declines in energy prices not only should help strengthen real income in the near term but also should contribute to an improvement in consumer sentiment and thus lend support to our forecast of continued moderate gains in consumer spending in coming months. We are projecting that real PCE will rise at an annual rate of 3 percent this quarter and at a 2¾ percent rate in the fourth quarter.

Although starts of new single-family homes declined only moderately further in July, a number of other indicators point to a sharper contraction in homebuilding over the remainder of the year: New permit issuance fell sharply again in July, reaching its lowest level since 2002; sales of both new and existing homes also dropped steeply.

, and the sector overall has seen a run-up in backlogs of unsold homes to the highest level (relative to sales) in ten years. These indicators suggest that the contraction in new residential construction is likely to be deeper and more prolonged than we had been projecting earlier. We now project that single-family starts will drop from 1.45 million units (annual rate) in July to 1.30 million units by the fourth quarter of this year before bottoming out at 1.25 million units in early 2007. As a result, real outlays for residential construction are expected to fall at an annual rate of just 20½ percent over the second half of this year, subtracting 1.3 percentage points each quarter from the rates of increase in real GDP.

Outlays for equipment and software are expected to increase at an annual rate of 7¼ percent over the final two quarters of the year—a pace similar to the average pace of the first half. While overall investment in high-tech equipment is projected to continue rising at an annual rate of 10½ percent, we are anticipating that outlays for computing equipment will accelerate with the planned introduction of new, more efficient hardware. At the same time, with the spurt in spending by telecom service providers behind us, outlays for communications equipment are expected to rise more slowly than they did earlier this year. Outlays for transportation equipment should be boosted by the sales of medium and heavy trucks, for which the current backlog of orders is quite high, and by a surge in deliveries of new aircraft at year-end. Orders for other business equipment through July also continued to outpace shipments, but demand is likely to slow somewhat as business sales decelerate. On balance, we are projecting that spending by domestic firms on other types of equipment will rise at a strong rate of 7 percent this quarter and then decelerate to a pace of 2¼ percent in the fourth quarter.

After a very strong upswing over the past three quarters, investment in nonresidential construction is expected to moderate, on balance, in the second half of this year. Although anecdotal reports and information on vacancy rates suggest that market conditions for investment in new buildings remain favorable, architectural billings—which tend to lead construction spending—have dropped back. In contrast, the near-term outlook for investment in drilling and mining remains robust.

Real nonfarm inventory investment is expected to moderate this quarter and next. Stocks of new motor vehicles are projected to be drawn down more quickly than we previously expected, as the scheduled reduction in assemblies corrects much of the current overhang. Inventory investment at non-auto businesses, which picked up in the second quarter, is expected to remain close to its recent level.

In the government sector, real federal expenditures on consumption and gross investment are expected to rise at an annual rate of 4¾ percent in the current quarter before decelerating to a 1¾ percent rate in the fourth quarter. This pattern is the result of a bulge in FEMA outlays this quarter and a relatively large increase in defense spending. Spending by state and local governments for construction is likely to moderate in coming quarters from the very robust rate of the first half of this year, while other outlays continue to increase at a moderate pace. Overall, real state and local expenditures are projected to rise at an annual rate of about 2 percent in the second half of this year.

Net exports are projected to be a relatively neutral influence on the forecast for real GDP over the second half of 2006 after having contributed 0.4 percentage point to the rise in real GDP last quarter. Real exports are expected to rise at an annual rate of 4¾ percent for the remainder of this year while real imports, which posted only a small rise in the second quarter, are expected to pick up, increasing at an annual rate of about 3½ percent.

The revisions to wages and salaries that were included in the most recent NIPA release also boosted the estimates of hourly compensation in the nonfarm business sector, putting the second-quarter level up 7¾ percent from a year earlier. This reading on labor compensation contrasts sharply with the rise of 2¾ percent in the employment cost index (ECI) over the same period. Some of the payments included in the new estimate of hourly compensation may well have been linked to profits or stock market performance and, thus, may not represent a sharp step-up in the marginal costs of production early this year. As noted, a portion of the increase likely represented option exercises (which are not included in the ECI). That said, we have assumed that a portion of the recent rise in compensation per hour represents greater upward pressure from labor costs than we had projected earlier.

Consistent with our assumption that part of the first-quarter surge in wages and salaries was a one-time increase, we have written down a small increase in hourly compensation for the third quarter—an annual rate of 1½ percent—and then a moderate rate of 4¾ percent in the fourth quarter. All in all, for the year as a whole, we have revised up the increase in hourly labor compensation to 6½ percent, 1 percentage point faster than in our previous projection.

Our near-term inflation projection has been altered noticeably by the recent decline in energy prices. We now expect that top-line PCE price inflation will slow to 2½ percent this quarter and then to less than ½ percent in the fourth quarter. Consumer energy prices are projected to drop a cumulative 11 percent in September and October. Core PCE prices rose a little less than we had projected in July, but our projections for the remaining months of the year are little changed at 0.2 percent per month, leaving the core rate at 2¼ percent this quarter and 2½ percent next quarter.

The Longer-Run Outlook for the Economy

We now project that real GDP will increase 2.1 percent in 2007, ¼ percentage point less than in the August forecast. Extending the forecast to 2008, we are showing an increase in real GDP of 2.4 percent. With the pace of real GDP averaging below our estimate of the potential rate from mid-2006 through mid-2008, we anticipate that a small gap will open in resource utilization and that the unemployment rate will move up to 5.2 percent in 2008.

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

Measure	2006 H1	2006 H2	2007	2008
Real GDP	**4.2**	**1.7**	**2.1**	**2.4**
Previous	**4.3**	**2.1**	**2.3**	. . .
Final sales	3.9	2.1	2.1	2.2
Previous	4.0	2.6	2.4	. . .
PCE	3.7	2.9	2.5	2.7
Previous	3.6	2.8	2.4	. . .
Residential investment	-5.8	-20.6	-7.5	2.2
Previous	-4.8	-14.0	-3.1	. . .
BFI	9.0	9.3	4.2	3.0
Previous	9.2	9.3	5.3	. . .
Government purchases	2.9	2.3	1.9	1.2
Previous	3.2	2.3	2.0	. . .
Exports	10.1	4.8	4.6	5.1
Previous	8.8	5.3	5.1	. . .
Imports	5.2	3.5	3.7	5.3
Previous	4.7	3.1	4.0	. . .
	Contribution to growth (percentage points)			
Inventory change	.3	-.3	-.0	.2
Previous	.4	-.4	-.1	. . .
Net exports	.2	-.1	-.1	-.3
Previous	.1	.1	-.1	. . .

. . . Not applicable.

Household spending. After having risen briskly during the past three years, consumer spending is projected to rise at a moderate rate in 2007 and 2008. As has been the case for some time, that projection is shaped importantly by our estimates of the effect of wealth on consumption. We believe that the wealth effect added ¾ percentage point to the rise in real PCE in 2005, and we estimate that it will contribute another ½ percentage point this year. Currently we are projecting that wealth will be a neutral factor in 2007 and will be a drag of about ¼ percentage point in 2008. Our current forecast for real PCE in 2007—an increase of 2½ percent—is slightly higher than the August forecast, largely because of the effects of the upward revision to real income and somewhat higher stock prices; in 2008, real PCE is projected to increase 2¾ percent.

As noted, our revised forecast for residential construction shows single-family housing starts continuing to decline in the second half of 2006 and falling a bit further early next year. Single-family starts are now projected to stabilize at an annual rate of 1.25 million units in 2007—150,000 units lower than in the previous forecast. In all, the contraction in new homebuilding from mid-2005, when starts peaked at an annual rate of 1.75 million units, corresponds to a cumulative decline of roughly 20 percent in real expenditures on residential investment.

On the demand side, we believe that during 2007 home sales will begin to firm as household income continues to rise at a relatively strong pace and mortgage rates remain at a level that is still low by historical norms. The cutbacks in starts that we are now forecasting, combined with our outlook for sales, appear sufficient, over time, to reduce the backlog of inventories at homebuilders. We are projecting that by 2008 single-family starts will begin to edge higher, ending the year at an annual rate of 1.30 million units. After subtracting almost ½ percentage point from the increase in real GDP in 2007, real residential investment rises modestly in 2008, adding 0.1 percentage point to the change in real GDP.

Business investment. In broad terms, the forecast for business investment in equipment and software (E&S) responds to the projected trajectory for changes in real output: Real outlays for E&S slow to 4¼ percent in 2007 and then firm somewhat, to about 5 percent, in 2008. Higher longer-term borrowing rates also contribute to the slowing in 2007. The pattern is most pronounced for spending on non-high-tech equipment, which is expected to rise 4¾ percent this year. Spending in this category is then projected to rise just 1¼ percent in 2007 before moving up 2¼ percent in 2008. Increases in real outlays on high-tech equipment and software are projected to be steady at an annual rate of around 9 percent over the forecast period.

The recovery in nonresidential investment is projected to extend into 2007, although the increase in spending on the construction of office and commercial space and on manufacturing facilities is not expected to be as robust as it has been so far this year. The lower level of energy prices in this forecast is expected to moderate the pace of spending on drilling and mining structures. As economic activity continues to rise slowly, we are projecting that total outlays for nonresidential construction will edge lower in 2008.

At present, we see little sign of inventory imbalances aside from those in the motor vehicle industry. Our forecast assumes that businesses will adjust their inventory investment reasonably promptly over the next year to the reduced pace of real activity. As a result, we do not expect swings in inventory investment to be an important factor influencing the contour of real activity over the 2007-08 period.

Government spending. Real federal expenditures on consumption and investment are projected to slow to an annual rate of 2 percent in 2007 and to be flat in 2008. Although real outlays in the nondefense category have fluctuated from quarter to quarter recently, they have been, on balance, unchanged this year and are expected to continue to be so through the end of the forecast period. At the same time, real defense spending is expected to decelerate—from an increase of 3.8 percent in 2006 to an increase of 2.8 percent in 2007—before it flattens out in 2008. In the state and local sector, we see a sustained moderate rise in real expenditures overall—at close to 2 percent per year—in 2007 and 2008. In particular, construction spending, which was quite weak in recent years, is projected to rise 4 percent per year in 2007 and 2008, reflecting the improved fiscal position of states.

Net exports. With real activity abroad projected to expand at a solid pace through 2008 and the foreign exchange value of the dollar assumed to move down modestly, real exports are projected to rise 4½ percent in 2007 and 5 percent in 2008. Real imports are expected to continue to increase at a moderate rate in 2007 and then to rise more quickly in 2008 as U.S. real GDP strengthens and relative import prices decline. As a result, real net exports of goods and services are expected to exert a slight drag on the rise in real GDP in 2007 but to subtract 0.3 percentage point from the increase in real GDP in 2008. *(The International Developments section provides more detail on the outlook for the external sector.)*

Aggregate Supply, the Labor Market, and Inflation

In this forecast, we have updated our estimate of potential output and extended it through 2008. We now assume that potential real GDP will increase 2.7 percent per year in 2006

Decomposition of Structural Labor Productivity
(Percent change, Q4 to Q4, except as noted)

Measure	1974-95	1996-2000	2001-04	2005	2006	2007	2008
Structural labor productivity	**1.5**	**2.5**	**3.0**	**2.7**	**2.8**	**2.8**	**2.7**
Previous	1.5	2.5	3.0	2.7	2.7	2.7	. . .
Contributions[1]							
Capital deepening	.7	1.4	.6	.6	.7	.7	.7
Previous	.7	1.4	.6	.6	.6	.7	. . .
Multifactor productivity	.5	.8	2.1	1.9	1.8	1.8	1.8
Previous	.5	.8	2.1	1.9	1.8	1.8	. . .
Labor composition	.3	.3	.3	.3	.2	.2	.2
MEMO							
Potential GDP	3.0	3.3	2.9	2.6	2.7	2.7	2.5
Previous	3.0	3.3	2.9	2.6	2.9	2.9	. . .

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 year shown.
1. Percentage points.
. . . Not applicable.

and 2007—0.2 percentage point less than in the August Greenbook.[1] In 2008, the steepening downward trend in labor force participation that we believe to be under way, combined with a smaller increase in the working-age population, shows through to a slightly slower increase in potential GDP of 2.5 percent. Structural productivity is assumed to continue to rise at an annual rate of 2¾ percent over the forecast period.

Productivity and the labor market. After having risen at an annual rate of close to 3 percent over the first half of 2006, productivity in the nonfarm business sector is projected to decelerate sharply—to an average annual rate of 1 percent in the second

[1] The downward revision is the result of some additional fine-tuning of our forecast of potential output in response to the revisions to the NIPA. We have reassessed the trends in hours worked. Specifically, the trend in total hours for the economy—which is relevant for potential output—deviates from the trend in hours in the nonfarm business sector—which is used in measuring structural productivity. The two trends in hours differ for two reasons: because the household and payroll surveys yield different estimates of employment in the nonfarm business sector and because of the sectoral difference in coverage (nonfarm business versus the overall economy). Previously, we had implicitly allowed the first difference—the statistical measurement—to affect our forecast for potential output. On reexamination, we concluded that it should more appropriately be excluded and that only the difference that reflects sectoral coverage should be allowed to show through to our forecast of potential output.

The Outlook for the Labor Market
(Percent change, Q4 to Q4, except as noted)

Measure	2005	2006	2007	2008
Output per hour, nonfarm business	2.5	1.9	2.4	2.7
Previous	2.6	2.4	2.5	. . .
Nonfarm private payroll employment	1.6	1.3	.2	.3
Previous	1.6	1.2	.4	. . .
Household survey employment	1.9	1.4	.3	.6
Previous	1.9	1.3	.3	. . .
Labor force participation rate[1]	66.1	66.1	65.7	65.5
Previous	66.1	66.0	65.7	. . .
Civilian unemployment rate[1]	5.0	4.8	5.1	5.2
Previous	5.0	4.8	5.2	. . .
MEMO				
GDP gap[2]	-.0	.2	-.4	-.5
Previous	-.0	.3	-.4	. . .

1. Percent, average for the fourth quarter.
2. Percent difference between actual and potential GDP in the fourth quarter of the year indicated. A negative number indicates that the economy is operating below potential.
. . . Not applicable.

half—as the rate of increase in real activity steps down and, in response, businesses only gradually adjust their hours worked. Nonetheless, we see additions to private nonfarm payrolls dropping from the pace of 110,000 per month seen recently to 50,000 per month by year-end.

We think that by early 2007, the level of actual productivity should be roughly in line with its structural trend. Thus, for the remainder of the forecast period, we expect businesses to hold employment and hours worked on a trajectory that keeps productivity increasing at just below our assumed trend rate in 2007 and at that rate in 2008. Accordingly, gains in private nonfarm employment are projected to average just 25,000 per month next year and in 2008. Because real GDP in 2007 and 2008 is projected to rise below its potential rate, we expect a gradual opening of a gap in resource utilization, with the unemployment rate rising to 5.2 percent during 2008.

Wages and prices. As noted above, we interpreted part of the outsized increase in hourly compensation (as measured in the productivity and costs statistics) over the first half of 2006 as transitory. Thus, our projection for that measure of hourly compensation

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

Measure	2005	2006	2007	2008
PCE chain-weighted price index	3.1	2.2	2.5	2.0
Previous	3.1	2.9	2.1	. . .
Food and beverages	2.1	2.5	2.4	2.2
Previous	2.1	2.4	2.3	. . .
Energy	21.2	-.6	5.6	-.0
Previous	21.2	10.4	-.1	. . .
Excluding food and energy	2.1	2.4	2.3	2.1
Previous	2.1	2.5	2.3	. . .
Consumer price index	3.7	2.5	2.7	2.1
Previous	3.7	3.4	2.3	. . .
Excluding food and energy	2.1	2.9	2.5	2.3
Previous	2.1	2.9	2.5	. . .
GDP chain-weighted price index	3.1	2.7	2.6	2.4
Previous	3.1	2.8	2.3	. . .
ECI for compensation of private industry workers[1]	2.9	3.2	4.1	4.1
Previous	2.9	3.2	3.8	. . .
Compensation per hour, nonfarm business sector	4.1	6.5	5.3	5.1
Previous	4.2	5.5	5.3	. . .
Prices of core nonfuel imports	2.2	3.1	1.4	1.0
Previous	2.2	3.3	1.4	. . .

1. December to December.
. . . Not applicable.

in the nonfarm business sector in 2007 is unchanged at 5¼ percent—well below this year's bulge of 6½ percent but noticeably higher than the average increase of 4 percent in 2004 and 2005. Over the longer run, the lower average rate of consumer price inflation in this forecast and the continuation of a higher unemployment rate work to stem some of the additional upward pressure on compensation. We expect hourly compensation to rise 5 percent in 2008. For the ECI, we expect to see some pickup in compensation over the second half of this year and in 2007. After having risen 2¾ percent over the year ending in the second quarter of this year, the ECI is anticipated to increase 4 percent in 2007 and 2008.

The most significant change in the contour of our forecast for overall consumer price inflation is the incorporation of the decline in the price of crude oil in the second half of this year and the lower level of that price thereafter. This lower path for oil prices now shows through as a sharp stepdown in PCE price inflation in the fourth quarter of this year rather than the more-extended slowing that we anticipated in the August forecast. Next year and beyond, the direct effects of our projected changes in energy prices are relatively small; consumer energy prices provide a small boost to overall PCE price inflation in 2007 and are a very small negative in 2008.

The forecast for core PCE price inflation in 2007, at 2.3 percent, is the same as our previous projection. Although we have incorporated slightly more upward pressure on prices from labor costs next year, we also expect less pressure from energy costs. As before, emerging slack in resource utilization should provide some restraint on inflation. Smaller increases in nonfuel commodity prices and in shelter prices also contribute to the slowing in core inflation in 2007. In 2008, the favorable effects of lower energy and commodity costs and the continuation of slack in resource utilization are expected to tilt core inflation down further—to 2.1 percent.

Financial Flows and Conditions

Domestic nonfinancial debt is estimated to have expanded at an average annual rate of 6¾ percent in the current quarter, down from 8 percent in the first half of this year and 9½ percent in 2005. We anticipate that the rise in domestic nonfinancial debt will moderate somewhat further over the projection period, averaging 6 percent in 2008.

The household sector contributes importantly to the slower rise in overall debt. Household debt is projected to expand at an annual rate of 7 percent in second half of this year, well below the 9¼ percent pace in the first half and the rise of nearly 12 percent in 2005. We expect further slowing over the forecast period as house price appreciation softens. Although the exceptional rise in household debt in recent years has pushed the financial obligations ratio well above its historical range, delinquency rates on consumer and mortgage loans have generally been quite low. Nonetheless, our outlook for sharply reduced gains in house prices—and the likelihood that some households will experience outright price declines—suggest some erosion in the financial conditions of households from recent strong levels.

We estimate that nonfinancial business debt expanded at an annual rate of about 7½ percent in the current quarter, off a bit from the robust pace in the first half of this year. We anticipate that over the projection period increases in business debt will taper off, with merger and acquisition activity, share repurchases, and borrowing for commercial real estate expected to fall back. Businesses have been drawing down their liquid assets, and we expect that trend to continue over the forecast period. Given our projection for flat profits, we anticipate that business default rates will rise modestly from their recent, historically low levels.

The projection for federal borrowing follows the broad contour of the budget deficit. Federal debt contracted in the second quarter as a result of buoyant tax receipts, but it is expected to expand 5¼ percent over the year as a whole and a bit more rapidly in 2007 and 2008. In the municipal sector, bond issuance to finance capital expenditures has remained strong this year. However, higher interest rates have cut into advance-refunding issuance, and improved fiscal positions have led to a contraction in short-term debt. Municipal debt is on track to decelerate a bit further in 2007 and 2008.

M2 is estimated to expand just 4 percent this year—well short of the increase in nominal GDP—as rising market interest rates have boosted the opportunity cost of holding liquid assets. With rates assumed to flatten out, M2 is projected to rise 5 percent in 2007 and 2008, matching the increase in nominal GDP in those years.

Alternative Simulations

In this section, we evaluate alternatives to the staff forecast using simulations of the FRB/US model. The first two scenarios address the risk that we have underestimated the inflationary pressures implied by recent increases in labor compensation. The third scenario, in contrast, considers a more benign outlook for prices because inflation turns out to be less persistent than assumed in the baseline. We then shift the focus from the supply side to risks surrounding aggregate demand—first, that the current housing market downturn will intensify more than we anticipate and, second, that the personal saving rate will be little changed over the forecast period. In all these scenarios, monetary policy responds to the change in the outlook as suggested by an estimated version of the Taylor rule. In the final scenario, we assume that monetary policy follows a path implied by quotes from the market for federal funds futures.

Greater wage pressure. In the baseline forecast, we have passed through to our price projection only a small portion of the large upward revision in hourly compensation that is reported to have occurred at the beginning of 2006. In contrast, in this scenario we assume that all the first-half's increase in labor costs represents an increase in the

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

Measure and scenario	2006 H1	2006 H2	2007 H1	2007 H2	2008
Real GDP					
Greenbook baseline	4.2	1.7	2.0	2.2	2.4
Greater wage pressure	4.2	2.2	1.7	1.6	2.0
Unanchored inflation expectations	4.2	2.2	1.7	1.6	2.0
Less inflation persistence	4.2	1.7	2.1	2.4	2.5
Housing slump	4.2	.6	1.3	2.0	2.5
Stronger aggregate demand	4.2	2.0	2.9	3.0	2.8
Market-based funds rate	4.2	1.7	2.0	2.3	2.7
Unemployment rate[1]					
Greenbook baseline	4.7	4.8	5.0	5.1	5.2
Greater wage pressure	4.7	4.7	4.9	5.1	5.4
Unanchored inflation expectations	4.7	4.7	4.9	5.1	5.4
Less inflation persistence	4.7	4.8	5.0	5.1	5.1
Housing slump	4.7	4.9	5.3	5.5	5.6
Stronger aggregate demand	4.7	4.8	4.8	4.8	4.6
Market-based funds rate	4.7	4.8	5.0	5.1	5.1
Core PCE inflation					
Greenbook baseline	2.5	2.4	2.4	2.3	2.1
Greater wage pressure	2.5	2.8	2.9	2.8	2.4
Unanchored inflation expectations	2.5	2.9	2.9	2.9	2.7
Less inflation persistence	2.5	2.3	2.0	1.8	1.6
Housing slump	2.5	2.4	2.4	2.3	2.0
Stronger aggregate demand	2.5	2.4	2.4	2.3	2.2
Market-based funds rate	2.5	2.4	2.4	2.3	2.2
Federal funds rate[1]					
Greenbook baseline	4.9	5.3	5.3	5.3	5.0
Greater wage pressure	4.9	5.6	5.8	5.8	5.0
Unanchored inflation expectations	4.9	5.6	5.8	5.8	5.3
Less inflation persistence	4.9	5.3	5.2	5.1	4.6
Housing slump	4.9	4.9	4.5	4.3	4.0
Stronger aggregate demand	4.9	5.4	5.8	6.2	6.4
Market-based funds rate	4.9	5.3	5.1	4.8	4.6

1. Percent, average for the final quarter of the period.

marginal cost of producing goods and services and that firms gradually pass this increase in costs to their customers in the form of higher prices. In addition, the FRB/US model interprets the first-quarter data as suggesting that wage inflation will remain somewhat elevated relative to baseline into next year. Under these conditions, prices rise steadily relative to baseline over the next two and half years, causing core PCE inflation to peak at almost 3 percent in the first half of next year. However, because long-run inflation expectations are assumed to remain firmly anchored, core PCE inflation moderates to less than 2½ percent in 2008 as firms largely complete their price adjustments. In response to higher inflation, the gradualist Taylor rule calls for the federal funds rate to rise to 5¾ percent in 2007 before falling back to baseline in 2008. Although consumer spending and real activity more broadly receive an initial boost from elevated wage gains, the tighter stance of policy helps to restrain the rise in real GDP over time, causing the unemployment rate to climb to almost 5½ percent by the end of 2008.

Unanchored inflation expectations. Greater wage pressures would have more-pronounced medium-term implications for price inflation if they were to lead to a ratcheting-up of inflation expectations. In this scenario, we build on the previous one by assuming that, rather than remaining anchored, long-run inflation expectations gradually climb 50 basis points relative to baseline in response to the faster rise in wages and prices. As in the previous scenario, core PCE inflation rises to close to 3 percent by early next year, but in contrast to the previous scenario, it remains at that pace in the second half and edges down to only 2¾ percent in 2008. Monetary policy under the gradualist Taylor rule responds by raising the funds rate to around 5¾ percent next year; but policy then eases less than in the previous scenario in 2008 as inflation fails to moderate substantially. Although the relatively tighter stance of policy provides little incremental restraint on real activity within the projection period—as before, the unemployment rate stands a little below 5½ percent in late 2008—the gradualist Taylor rule would in the longer run induce sufficient economic slack to bring inflation slowly back to baseline.

Less inflation persistence. The baseline forecast assumes that inflation expectations are somewhat better anchored than in the past but that inflation still displays considerable persistence.[2] In this scenario, we instead allow inflation to be less persistent—perhaps for structural reasons or because of enhanced policy credibility. As a result, inflation returns more rapidly to the lower rate that prevailed before the run-up in energy prices began in late 2003. Specifically, core PCE inflation falls below 2 percent next year and settles just above 1½ percent in 2008—the average rate of inflation experienced from

[2] For a discussion of related evidence, see the September 12, 2006, memo to the FOMC, "Changes in Inflation Dynamics and Their Implications for Monetary Policy," by Laubach, Lebow, Roberts, Rudd, and Tetlow.

1995 through 2003. In response, monetary policy gradually lowers the federal funds rate to 4½ percent, thereby helping to modestly stimulate real activity. As a result, the unemployment rate levels out close to the staff estimate of the NAIRU.

Housing slump. Although the baseline projection includes a substantial downturn in the housing market, homebuilders will probably still hold a large number of unsold homes into next year. Moreover, even with the deceleration in home price appreciation in this projection, house prices in 2007 would remain overvalued by about 20 percent, according to some of our estimates. In this scenario, real residential investment is assumed to fall an additional 20 percent relative to baseline by the middle of next year; thereafter construction activity begins to recover slowly. In addition, home prices fall sharply through the end of next year, eliminating the estimated market overvaluation and shaving almost $4½ trillion from household wealth. The reductions in employment and income implied by the falloff in homebuilding, coupled with the loss in wealth, directly damp consumer spending and indirectly depress business investment. Overall, real GDP increases at an annual rate of about ½ percent in the second half of this year and 1½ percent in 2007. As a result, the unemployment rate climbs to 5½ percent next year and edges up further in 2008, causing core PCE inflation to edge down 0.2 percentage point relative to the baseline. In response to weaker real activity and lower inflation, the federal funds rate gradually falls to 4 percent.

Stronger aggregate demand. An important feature of the baseline forecast is that the personal saving rate rises gradually over the next two years as consumers continue to adjust their spending to past and projected movements in income, wealth, and interest rates. In this scenario, households are instead comfortable with allowing their spending to rise in line with income; the demand for housing is also somewhat stronger than in the staff forecast. As a result, the saving rate remains close to zero. Despite additional policy tightening that brings the federal funds rate to nearly 6½ percent by the end of 2008, real GDP expands at an annual rate of close to 3 percent over the next two years, and the unemployment rate gradually edges down to 4½ percent. Because the tighter stance of policy essentially eliminates the dollar depreciation incorporated into the baseline forecast, the inflationary effects of a higher degree of resource utilization are partially offset by a greater deceleration in import prices; on net, core PCE inflation is only a bit higher than in the baseline in 2008.

Market-based funds rate. Quotes from futures markets imply a path for the funds rate that averages about 25 basis points below the staff's assumed path in 2007 and about

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

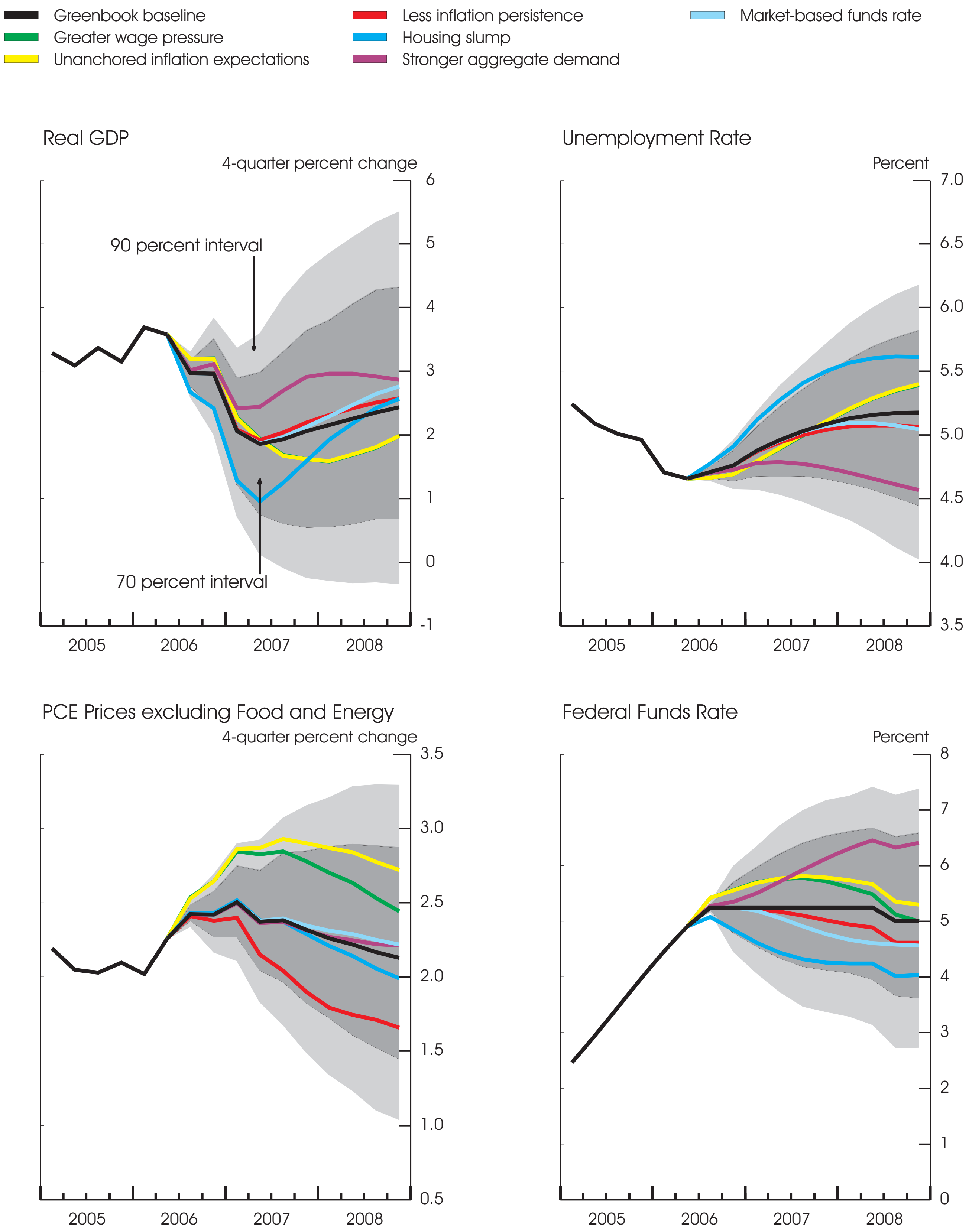
Measure	2006	2007	2008
Real GDP			
(percent change, Q4 to Q4)			
Projection	3.0	2.1	2.4
Confidence interval			
Greenbook forecast errors	2.1–3.8	.5–3.7	.7–4.2
FRB/US stochastic simulations	2.4–3.5	.6–3.6	.7–4.3
Civilian unemployment rate			
(percent, Q4)			
Projection	4.8	5.1	5.2
Confidence interval			
Greenbook forecast errors	4.5–5.0	4.4–5.8	4.0–6.4
FRB/US stochastic simulations	4.6–4.9	4.7–5.5	4.4–5.8
PCE prices			
excluding food and energy			
(percent change, Q4 to Q4)			
Projection	2.4	2.3	2.1
Confidence interval			
Greenbook forecast errors	2.1–2.7	1.6–3.0	1.0–3.2
FRB/US stochastic simulations	2.3–2.6	1.8–2.9	1.4–2.9
Federal funds rate			
(percent, Q4)			
Projection	5.2	5.2	5.0
Confidence interval			
FRB/US stochastic simulations	4.8–5.7	4.1–6.5	3.6–6.6

Note. Shocks underlying FRB/US stochastic simulations are randomly drawn from the 1986-2004 set of model equation residuals. Intervals derived from Greenbook forecast errors are based on the 1986-2004 set of Greenbook historical errors.

50 basis points below that baseline path in 2008. If the funds rate were to follow the market's expectations, the easier stance of policy would boost the rise in real GDP in 2008 to 2¾ percent. Partly in response to stronger real activity, core PCE inflation would be marginally above baseline in 2008.

Forecast Confidence Intervals and Alternative Scenarios under the Assumption that Monetary Policy Follows an Estimated Taylor Rule

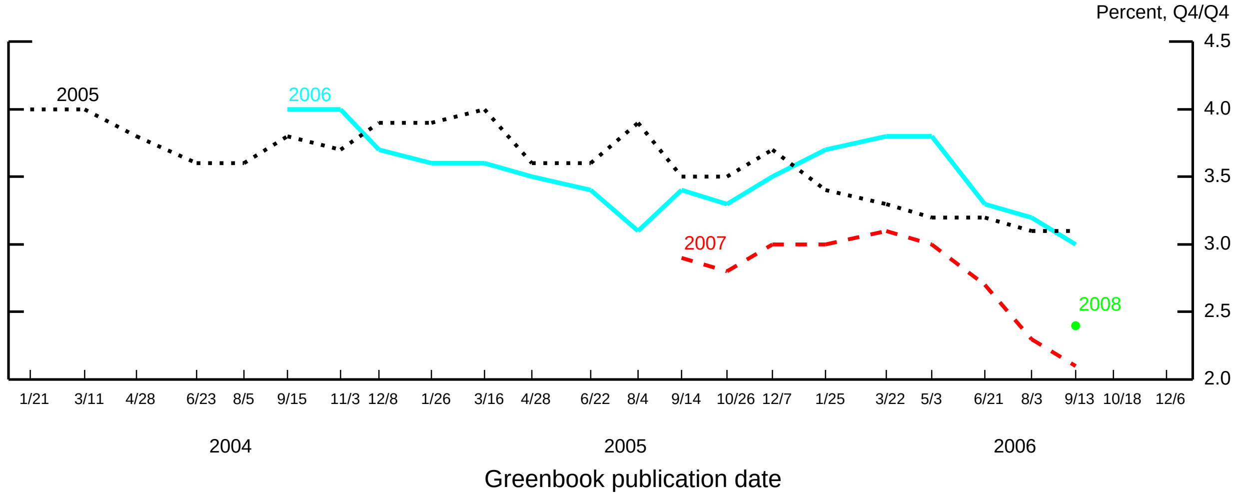
Confidence Intervals based on FRB/US Stochastic Simulations



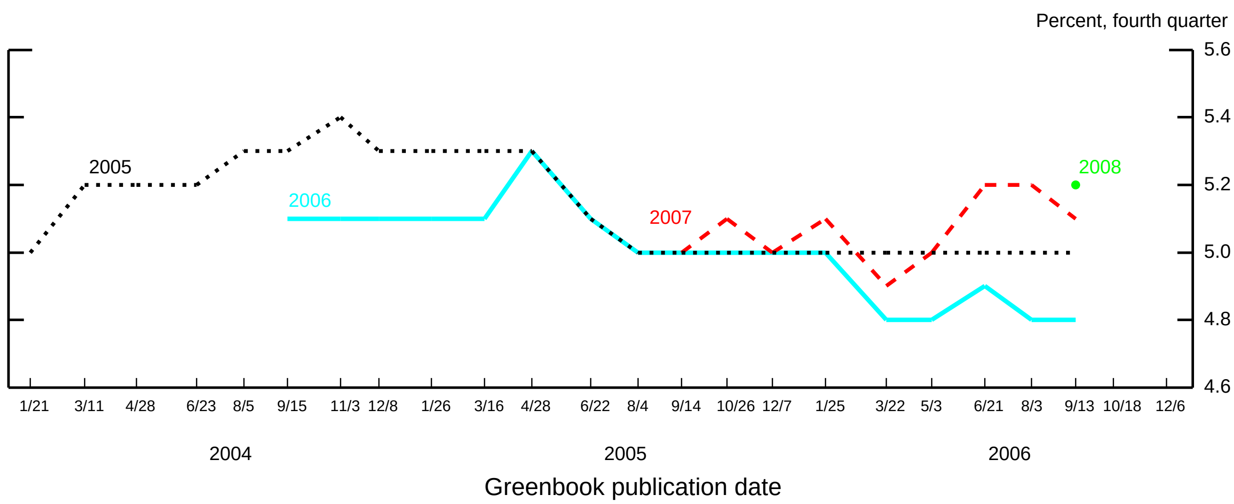
Class II FOMC - Restricted (FR)

Evolution of the Staff Forecast

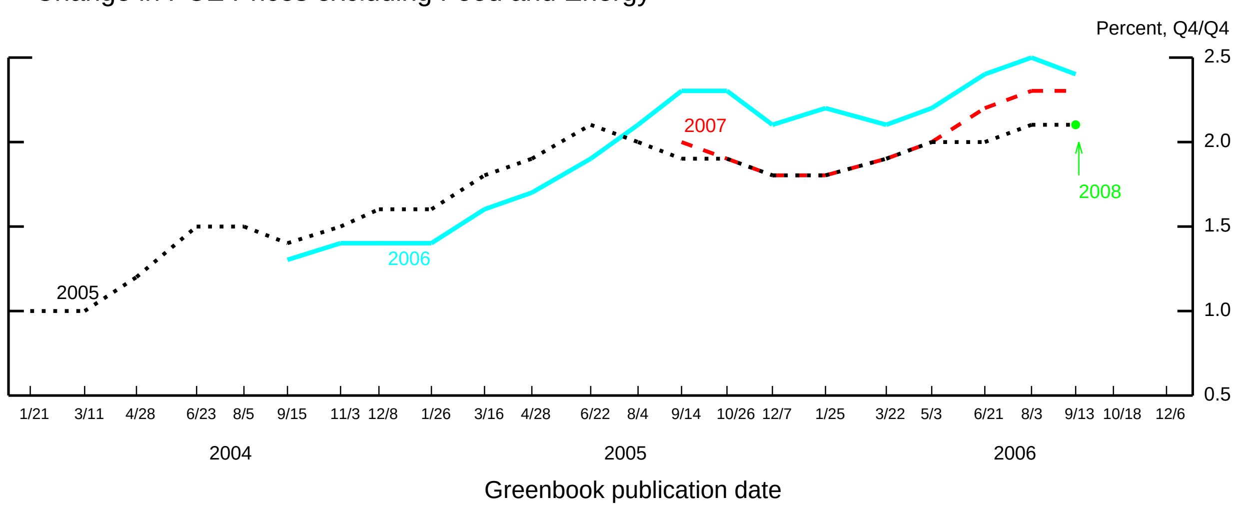
Change in Real GDP



Unemployment Rate



Change in PCE Prices excluding Food and Energy



Changes in GDP, Prices, and Unemployment
(Percent, annual rate except as noted)

Interval	Nominal GDP		Real GDP		PCE price index		Core PCE price index		Unemployment rate[1]	
	8/3/06	9/13/06	8/3/06	9/13/06	8/3/06	9/13/06	8/3/06	9/13/06	8/3/06	9/13/06
Quarterly										
2006:Q1	9.0	9.0	5.6	5.6	2.0	2.0	2.1	2.1	4.7	4.7
Q2	6.5	6.3	3.0	2.8	4.1	4.1	2.9	2.8	4.7	4.7
Q3	5.3	4.0	2.2	1.8	3.5	2.5	2.5	2.3	4.7	4.7
Q4	3.7	3.7	2.1	1.7	2.1	.3	2.5	2.5	4.8	4.8
2007:Q1	4.3	4.6	2.2	1.9	2.0	2.9	2.4	2.4	4.9	4.9
Q2	4.9	4.9	2.3	2.0	2.2	2.5	2.3	2.3	5.0	5.0
Q3	4.8	4.8	2.3	2.1	2.2	2.4	2.2	2.3	5.1	5.0
Q4	4.7	4.6	2.4	2.2	2.1	2.2	2.2	2.2	5.2	5.1
2008:Q1	...	4.9	...	2.3	...	2.1	...	2.2	...	5.1
Q2	...	5.1	...	2.4	...	2.1	...	2.2	...	5.2
Q3	...	4.9	...	2.5	...	2.0	...	2.1	...	5.2
Q4	...	4.8	...	2.5	...	2.0	...	2.1	...	5.2
Two-quarter[2]										
2006:Q2	7.7	7.6	4.3	4.2	3.1	3.1	2.5	2.5	-.3	-.3
Q4	4.5	3.9	2.1	1.7	2.8	1.4	2.5	2.4	.1	.1
2007:Q2	4.6	4.7	2.2	2.0	2.1	2.7	2.3	2.4	.2	.2
Q4	4.8	4.7	2.3	2.2	2.1	2.3	2.2	2.3	.2	.1
2008:Q2	...	5.0	...	2.4	...	2.1	...	2.2	...	.1
Q4	...	4.9	...	2.5	...	2.0	...	2.1	...	.0
Four-quarter[3]										
2005:Q4	6.4	6.4	3.1	3.1	3.1	3.1	2.1	2.1	-.4	-.4
2006:Q4	6.1	5.7	3.2	3.0	2.9	2.2	2.5	2.4	-.2	-.2
2007:Q4	4.7	4.7	2.3	2.1	2.1	2.5	2.3	2.3	.4	.3
2008:Q4	...	4.9	...	2.4	...	2.0	...	2.1	...	.1
Annual										
2005	6.3	6.3	3.2	3.2	2.9	2.9	2.1	2.1	5.1	5.1
2006	6.6	6.4	3.4	3.3	3.1	2.9	2.3	2.3	4.7	4.7
2007	4.7	4.5	2.3	2.0	2.4	2.3	2.4	2.4	5.0	5.0
2008	...	4.9	...	2.3	...	2.2	...	2.2	...	5.2

1. Level, except for two-quarter and four-quarter intervals.
2. Percent change from two quarters earlier; for unemployment rate, change is in percentage points.
3. Percent change from four quarters earlier; for unemployment rate, change is in percentage points.

Changes in Real Gross Domestic Product and Related Items
(Percent, annual rate except as noted)

Item	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2006[1]	2007[1]	2008[1]
Real GDP	5.6	2.8	1.8	1.7	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.5	3.0	2.1	2.4
Previous	5.6	3.0	2.2	2.1	2.2	2.3	2.3	2.4	. . .	. . .	. . .	. . .	3.2	2.3	. . .
Final sales	5.6	2.1	2.3	1.8	1.5	2.5	2.6	1.9	1.8	2.6	2.6	1.9	3.0	2.1	2.2
Previous	5.6	2.3	2.9	2.3	2.0	2.8	2.7	1.9	. . .	. . .	. . .	. . .	3.3	2.4	. . .
Priv. dom. final purch.	5.5	1.8	2.1	1.8	1.4	2.2	2.4	2.5	2.6	2.7	2.8	2.8	2.8	2.1	2.7
Previous	5.5	1.9	2.5	2.3	2.1	2.5	2.5	2.5	. . .	. . .	. . .	. . .	3.0	2.4	. . .
Personal cons. expend.	4.8	2.6	3.1	2.7	2.5	2.5	2.6	2.6	2.6	2.7	2.8	2.8	3.3	2.5	2.7
Previous	4.8	2.5	3.2	2.5	2.4	2.4	2.4	2.4	. . .	. . .	. . .	. . .	3.2	2.4	. . .
Durables	19.8	.5	5.4	3.5	4.0	4.3	4.3	4.3	4.1	4.4	4.5	4.6	7.0	4.2	4.4
Nondurables	5.9	1.7	2.4	2.7	3.0	3.0	3.0	3.1	3.2	3.2	3.2	3.3	3.1	3.0	3.2
Services	1.6	3.5	3.1	2.5	1.9	2.0	2.0	2.1	2.1	2.1	2.2	2.2	2.7	2.0	2.2
Residential investment	-.3	-10.9	-20.6	-20.5	-17.4	-7.6	-3.2	-.8	.8	1.5	3.1	3.3	-13.5	-7.5	2.2
Previous	-.3	-9.0	-16.4	-11.6	-7.7	-2.7	-1.3	-.6	. . .	. . .	. . .	. . .	-9.5	-3.1	. . .
Business fixed invest.	13.7	4.4	9.5	9.2	4.7	4.8	3.8	3.6	3.5	3.1	2.9	2.4	9.1	4.2	3.0
Previous	13.7	4.9	9.7	9.0	5.7	5.9	4.9	4.6	. . .	. . .	. . .	. . .	9.3	5.3	. . .
Equipment & software	15.6	-1.5	7.1	7.5	3.8	5.0	4.2	4.3	4.9	4.8	5.1	5.0	7.0	4.3	4.9
Previous	15.6	-1.1	8.5	7.8	4.4	5.5	5.2	5.2	. . .	. . .	. . .	. . .	7.5	5.0	. . .
Nonres. structures	8.7	21.0	15.4	13.0	6.7	4.4	2.8	2.2	.6	-.4	-1.5	-2.9	14.5	4.0	-1.0
Previous	8.7	21.6	12.4	11.9	8.8	6.8	4.3	3.4	. . .	. . .	. . .	. . .	13.6	5.8	. . .
Net exports[2]	-637	-624	-625	-627	-634	-628	-622	-638	-658	-656	-656	-676	-628	-631	-661
Previous[2]	-637	-627	-618	-622	-630	-623	-615	-632	. . .	. . .	. . .	. . .	-626	-625	. . .
Exports	14.0	6.3	4.7	4.9	4.7	4.7	4.6	4.5	4.7	5.0	5.2	5.3	7.4	4.6	5.1
Imports	9.1	1.5	3.2	3.8	4.5	2.0	2.0	6.4	7.1	3.1	3.4	7.8	4.4	3.7	5.3
Govt. cons. & invest.	4.9	.9	2.7	1.9	2.4	2.1	1.7	1.5	1.2	1.2	1.2	1.2	2.6	1.9	1.2
Previous	4.9	1.6	2.1	2.4	2.5	2.2	1.8	1.6	. . .	. . .	. . .	. . .	2.7	2.0	. . .
Federal	8.8	-4.3	4.6	1.7	3.2	2.3	1.3	.7	.0	.0	.0	.0	2.6	1.9	.0
Defense	8.9	-1.8	4.5	4.0	4.7	3.5	1.9	1.1	.0	.0	.0	.0	3.8	2.8	.0
Nondefense	8.5	-9.3	5.0	-2.8	.0	.0	.0	.0	.0	.0	.0	.0	.1	.0	.0
State & local	2.7	4.1	1.6	2.0	1.9	2.0	1.9	1.9	1.9	1.9	1.9	1.9	2.6	1.9	1.9
Change in bus. inventories[2]	41	60	46	44	57	44	31	40	54	50	45	64	48	43	53
Previous[2]	41	62	44	39	43	29	16	32	. . .	. . .	. . .	. . .	46	30	. . .
Nonfarm[2]	37	57	46	44	57	43	30	40	54	49	44	63	46	42	53
Farm[2]	4	4	1	1	1	1	1	1	1	1	1	1	3	1	1

1. Change from fourth quarter of previous year to fourth quarter of year indicated.
2. Billions of chained (2000) dollars.

Changes in Real Gross Domestic Product and Related Items
(Percent, annual rate except as noted)

Item	2000[1]	2001[1]	2002[1]	2003[1]	2004[1]	2005[1]	2006[1]	2007[1]	2008[1]
Real GDP	2.2	.2	1.9	3.7	3.4	3.1	3.0	2.1	2.4
Previous	2.2	.2	1.9	3.7	3.4	3.1	3.2	2.3	. . .
Final sales	2.9	1.5	.8	3.7	3.1	3.2	3.0	2.1	2.2
Previous	2.9	1.5	.8	3.7	3.1	3.2	3.3	2.4	. . .
Priv. dom. final purch.	4.3	1.0	1.1	4.1	4.4	3.6	2.8	2.1	2.7
Previous	4.3	1.0	1.1	4.1	4.4	3.6	3.0	2.4	. . .
Personal cons. expend.	4.1	2.8	1.9	3.4	4.0	2.9	3.3	2.5	2.7
Previous	4.1	2.8	1.9	3.4	4.0	2.9	3.2	2.4	. . .
Durables	4.7	10.8	1.2	8.3	5.6	2.5	7.0	4.2	4.4
Nondurables	3.0	1.9	2.1	3.9	3.8	4.4	3.1	3.0	3.2
Services	4.5	1.6	1.9	2.2	3.7	2.3	2.7	2.0	2.2
Residential investment	-1.9	1.4	7.0	11.7	6.1	9.0	-13.5	-7.5	2.2
Previous	-1.9	1.4	7.0	11.7	6.1	9.0	-9.5	-3.1	. . .
Business fixed invest.	7.8	-9.6	-6.5	4.9	6.9	5.6	9.1	4.2	3.0
Previous	7.8	-9.6	-6.5	4.9	6.9	5.6	9.3	5.3	. . .
Equipment & software	7.5	-9.0	-3.4	6.6	8.3	7.0	7.0	4.3	4.9
Previous	7.5	-9.0	-3.4	6.6	8.3	7.0	7.5	5.0	. . .
Nonres. structures	8.8	-11.1	-14.9	.2	2.7	1.8	14.5	4.0	-1.0
Previous	8.8	-11.1	-14.9	.2	2.7	1.8	13.6	5.8	. . .
Net exports[2]	-379	-399	-471	-519	-591	-619	-628	-631	-661
Previous[2]	-379	-399	-471	-519	-591	-619	-626	-625	. . .
Exports	6.5	-11.9	3.8	5.8	7.0	6.7	7.4	4.6	5.1
Imports	11.2	-7.6	9.7	4.8	10.6	5.2	4.4	3.7	5.3
Govt. cons. & invest.	.4	5.0	4.0	1.7	1.1	1.2	2.6	1.9	1.2
Previous	.4	5.0	4.0	1.7	1.1	1.2	2.7	2.0	. . .
Federal	-2.2	6.4	7.8	5.5	2.3	2.1	2.6	1.9	.0
Defense	-3.5	6.5	8.4	7.5	2.5	1.9	3.8	2.8	.0
Nondefense	.3	6.3	6.8	1.9	1.8	2.4	.1	.0	.0
State & local	1.7	4.2	2.1	-.4	.4	.8	2.6	1.9	1.9
Change in bus. inventories[2]	56	-32	12	14	53	20	48	43	53
Previous[2]	56	-32	12	14	53	20	46	30	. . .
Nonfarm[2]	58	-32	15	14	47	20	46	42	53
Farm[2]	-1	0	-2	0	6	0	3	1	1

1. Change from fourth quarter of previous year to fourth quarter of year indicated.
2. Billions of chained (2000) dollars.

Contributions to Changes in Real Gross Domestic Product
(Percentage points, annual rate except as noted)

Item	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2006[1]	2007[1]	2008[1]
Real GDP	5.6	2.8	1.8	1.7	1.9	2.0	2.1	2.2	2.3	2.4	2.5	2.5	3.0	2.1	2.4
Previous	5.6	3.0	2.2	2.1	2.2	2.3	2.3	2.4	. . .	. . .	. . .	. . .	3.2	2.3	. . .
Final sales	5.6	2.1	2.3	1.8	1.5	2.5	2.5	1.9	1.8	2.6	2.6	1.9	2.9	2.1	2.2
Previous	5.6	2.3	2.8	2.2	2.0	2.8	2.7	1.9	. . .	. . .	. . .	. . .	3.2	2.3	. . .
Priv. dom. final purch.	4.7	1.6	1.8	1.6	1.2	1.9	2.0	2.2	2.3	2.3	2.4	2.4	2.4	1.8	2.3
Previous	4.7	1.7	2.1	2.0	1.9	2.2	2.1	2.2	. . .	. . .	. . .	. . .	2.6	2.1	. . .
Personal cons. expend.	3.4	1.8	2.2	1.9	1.7	1.8	1.8	1.8	1.9	1.9	1.9	2.0	2.3	1.8	1.9
Previous	3.4	1.7	2.2	1.7	1.7	1.7	1.7	1.7	. . .	. . .	. . .	. . .	2.3	1.7	. . .
Durables	1.5	.0	.4	.3	.3	.3	.3	.3	.3	.3	.4	.4	.6	.3	.3
Nondurables	1.2	.3	.5	.6	.6	.6	.6	.6	.7	.7	.7	.7	.6	.6	.7
Services	.7	1.4	1.3	1.0	.8	.8	.8	.9	.9	.9	.9	.9	1.1	.8	.9
Residential investment	.0	-.7	-1.3	-1.3	-1.0	-.4	-.2	.0	.0	.1	.1	.2	-.8	-.4	.1
Previous	.0	-.6	-1.1	-.7	-.4	-.1	-.1	.0	. . .	. . .	. . .	. . .	-.6	-.2	. . .
Business fixed invest.	1.4	.5	1.0	.9	.5	.5	.4	.4	.4	.3	.3	.3	.9	.5	.3
Previous	1.4	.5	1.0	.9	.6	.6	.5	.5	. . .	. . .	. . .	. . .	.9	.6	. . .
Equipment & software	1.1	-.1	.5	.5	.3	.4	.3	.3	.4	.3	.4	.4	.5	.3	.4
Previous	1.1	-.1	.6	.6	.3	.4	.4	.4	. . .	. . .	. . .	. . .	.6	.4	. . .
Nonres. structures	.3	.6	.4	.4	.2	.1	.1	.1	.0	.0	-.1	-.1	.4	.1	.0
Previous	.3	.6	.4	.4	.3	.2	.1	.1	. . .	. . .	. . .	. . .	.4	.2	. . .
Net exports	.0	.4	.0	-.1	-.2	.2	.2	-.6	-.7	.0	.0	-.7	.1	-.1	-.3
Previous	.0	.3	.3	-.2	-.3	.2	.2	-.6	. . .	. . .	. . .	. . .	.1	-.1	. . .
Exports	1.4	.7	.5	.5	.5	.5	.5	.5	.5	.6	.6	.6	.8	.5	.6
Imports	-1.5	-.3	-.5	-.6	-.8	-.3	-.3	-1.1	-1.2	-.5	-.6	-1.3	-.7	-.6	-.9
Govt. cons. & invest.	.9	.2	.5	.4	.5	.4	.3	.3	.2	.2	.2	.2	.5	.4	.2
Previous	.9	.3	.4	.5	.5	.4	.4	.3	. . .	. . .	. . .	. . .	.5	.4	. . .
Federal	.6	-.3	.3	.1	.2	.2	.1	.1	.0	.0	.0	.0	.2	.1	.0
Defense	.4	-.1	.2	.2	.2	.2	.1	.1	.0	.0	.0	.0	.2	.1	.0
Nondefense	.2	-.2	.1	-.1	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0
State & local	.3	.5	.2	.2	.2	.2	.2	.2	.2	.2	.2	.2	.3	.2	.2
Change in bus. inventories	.0	.7	-.5	-.1	.5	-.5	-.5	.3	.5	-.2	-.2	.6	.0	.0	.2
Previous	.0	.7	-.7	-.2	.1	-.5	-.4	.5	. . .	. . .	. . .	. . .	.0	-.1	. . .
Nonfarm	.0	.7	-.4	-.1	.5	-.5	-.5	.3	.5	-.2	-.2	.6	.0	.0	.2
Farm	.0	.0	-.1	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0	.0

1. Change from fourth quarter of previous year to fourth quarter of year indicated.

Changes in Prices and Costs
(Percent, annual rate except as noted)

Item	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2006[1]	2007[1]	2008[1]
GDP chain-wt. price index	3.3	3.4	2.2	1.9	2.6	2.8	2.6	2.3	2.5	2.6	2.4	2.2	2.7	2.6	2.4
Previous	3.3	3.3	3.0	1.6	2.1	2.6	2.5	2.2	...	...	...	...	2.8	2.3	...
PCE chain.-wt. price index	2.0	4.1	2.5	.3	2.9	2.5	2.4	2.2	2.1	2.1	2.0	2.0	2.2	2.5	2.0
Previous	2.0	4.1	3.5	2.1	2.0	2.2	2.2	2.1	...	...	...	...	2.9	2.1	...
Energy	.1	29.7	5.0	-28.4	11.1	5.8	3.9	1.7	.7	.1	-.3	-.5	-.6	5.6	.0
Previous	.1	29.7	18.6	-3.4	-2.6	.8	1.2	.1	...	...	...	...	10.4	-.1	...
Food	2.7	1.7	2.8	2.6	2.4	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.5	2.4	2.2
Previous	2.7	1.7	2.8	2.5	2.4	2.4	2.4	2.3	...	...	...	...	2.4	2.3	...
Ex. food & energy	2.1	2.8	2.3	2.5	2.4	2.3	2.3	2.2	2.2	2.2	2.1	2.1	2.4	2.3	2.1
Previous	2.1	2.9	2.5	2.5	2.4	2.3	2.2	2.2	...	...	...	...	2.5	2.3	...
CPI	2.2	4.9	3.1	-.2	3.3	2.8	2.6	2.3	2.2	2.1	2.0	2.0	2.5	2.7	2.1
Previous	2.2	4.9	4.2	2.3	2.1	2.4	2.3	2.2	...	...	...	...	3.4	2.3	...
Ex. food & energy	2.4	3.6	3.0	2.9	2.6	2.5	2.5	2.4	2.4	2.4	2.3	2.3	2.9	2.5	2.3
Previous	2.4	3.6	3.0	2.9	2.6	2.5	2.4	2.4	...	...	...	...	2.9	2.5	...
ECI, hourly compensation[2]	2.4	3.2	3.6	3.8	4.0	4.0	4.1	4.1	4.1	4.1	4.1	4.1	3.2	4.1	4.1
Previous[2]	2.4	3.2	3.6	3.6	3.7	3.8	3.8	3.9	...	...	...	...	3.2	3.8	...
Nonfarm business sector															
Output per hour	4.3	1.4	.4	1.6	2.4	2.4	2.4	2.6	2.6	2.7	2.8	2.9	1.9	2.4	2.7
Previous	4.0	2.2	1.6	2.0	2.3	2.4	2.5	2.6	...	...	...	...	2.4	2.5	...
Compensation per hour	13.7	6.6	1.5	4.8	5.3	5.3	5.3	5.3	5.2	5.2	5.1	5.1	6.5	5.3	5.1
Previous	6.4	5.4	5.0	5.3	5.3	5.3	5.3	5.3	...	...	...	...	5.5	5.3	...
Unit labor costs	9.0	5.1	1.1	3.2	2.8	2.8	2.8	2.7	2.6	2.4	2.2	2.1	4.5	2.8	2.3
Previous	2.3	3.2	3.4	3.2	2.9	2.8	2.8	2.7	...	...	...	...	3.0	2.8	...

1. Change from fourth quarter of previous year to fourth quarter of year indicated.
2. Private-industry workers.

Other Macroeconomic Indicators

Item	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2006[1]	2007[1]	2008[1]
Employment and production															
Nonfarm payroll employment[2]	.6	.4	.4	.3	.1	.1	.1	.1	.1	.1	.1	.1	1.6	.4	.5
Unemployment rate[3]	4.7	4.7	4.7	4.8	4.9	5.0	5.0	5.1	5.1	5.2	5.2	5.2	4.8	5.1	5.2
Previous[3]	4.7	4.7	4.7	4.8	4.9	5.0	5.1	5.2	...	...	...	...	4.8	5.2	...
GDP gap[4]	.7	.7	.5	.2	.0	-.1	-.3	-.4	-.4	-.5	-.5	-.5	.2	-.4	-.5
Previous[4]	.6	.6	.5	.3	.1	-.1	-.2	-.4	...	...	...	...	.3	-.4	...
Industrial production[5]	5.1	6.2	5.5	2.3	4.1	3.6	3.4	3.1	3.2	3.3	3.4	2.7	4.8	3.6	3.2
Previous[5]	5.1	6.6	5.4	3.9	3.8	3.4	3.2	3.2	...	...	...	...	5.3	3.4	...
Manufacturing industr. prod.[5]	5.3	5.1	4.7	2.7	4.0	3.6	3.5	3.5	3.9	3.6	3.7	3.4	4.5	3.7	3.6
Previous[5]	5.3	5.4	4.8	4.1	3.8	3.5	3.4	3.5	...	...	...	...	4.9	3.6	...
Capacity utilization rate - mfg.[3]	80.3	80.8	81.2	81.3	81.5	81.6	81.7	81.6	81.7	81.7	81.8	81.7	81.3	81.6	81.7
Previous[3]	80.3	80.9	81.3	81.6	81.8	81.9	81.9	81.9	...	...	...	...	81.6	81.9	...
Housing starts[6]	2.1	1.9	1.7	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.7	1.9	1.6	1.6
Light motor vehicle sales[6]	16.9	16.3	16.6	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.6	16.6	16.6	16.5	16.5
Income and saving															
Nominal GDP[5]	9.0	6.3	4.0	3.7	4.6	4.9	4.8	4.6	4.9	5.1	4.9	4.8	5.7	4.7	4.9
Real disposable pers. income[5]	4.6	1.6	3.2	5.1	3.8	2.9	3.7	3.6	4.4	2.9	3.4	3.2	3.6	3.5	3.5
Previous[5]	1.7	1.0	3.5	4.4	5.2	3.7	3.8	4.0	...	...	...	...	2.6	4.2	...
Personal saving rate[3]	-.3	-.6	-.6	.0	.3	.4	.7	1.0	1.4	1.4	1.6	1.7	.0	1.0	1.7
Previous[3]	-1.0	-1.5	-1.3	-.9	-.2	.2	.5	.9	...	...	...	...	-.9	.9	...
Corporate profits[7]	60.8	12.7	1.3	-5.1	-3.4	-4.4	-1.2	-.3	-1.1	4.5	3.0	2.6	14.9	-2.3	2.2
Profit share of GNP[3]	12.0	12.2	12.1	11.9	11.7	11.4	11.3	11.1	11.0	11.0	10.9	10.9	11.9	11.1	10.9
Net federal saving[8]	-147	-127	-194	-196	-222	-231	-237	-248	-279	-273	-267	-272	-166	-235	-273
Net state & local saving[8]	13	28	9	22	20	23	14	15	17	20	13	13	18	18	16
Gross national saving rate[3]	14.4	14.4	13.8	14.0	13.9	13.7	13.7	13.6	13.6	13.7	13.7	13.7	14.0	13.6	13.7
Net national saving rate[3]	2.9	3.1	2.4	2.7	2.5	2.3	2.3	2.3	2.3	2.4	2.4	2.4	2.7	2.3	2.4

1. Change from fourth quarter of previous year to fourth quarter of year indicated, unless otherwise indicated.
2. Change, millions.
3. Percent, annual values are for the fourth quarter of the year indicated.
4. Percent difference between actual and potential GDP; a negative number indicates that the economy is operating below potential. (In previous Greenbooks, we expressed the GDP gap with the opposite sign, so that a positive number indicated that actual output fell short of potential.) Annual values are for the fourth quarter of the year indicated.
5. Percent change, annual rate.
6. Level, millions, annual values are annual averages.
7. Percent change, annual rate, with inventory valuation and capital consumption adjustments.
8. Billions of dollars, annual values are annual averages.

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

Item	Fiscal year				2006				2007				2008			
	2005[a]	2006	2007	2008	Q1[a]	Q2[a]	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Not seasonally adjusted											
Unified budget																
Receipts[1]	2154	2385	2499	2638	507	772	575	566	525	804	603	596	560	850	633	616
Outlays[1]	2472	2651	2782	2946	691	676	635	690	726	697	669	747	746	733	720	778
Surplus/deficit[1]	-318	-266	-283	-308	-184	96	-59	-123	-201	107	-66	-151	-187	116	-87	-162
Previous	*-318*	*-281*	*-310*	*n.a.*	*-184*	*96*	*-75*	*-119*	*-205*	*95*	*-81*	*-145*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
On-budget	-494	-455	-476	-513	-216	11	-80	-189	-225	17	-80	-220	-212	21	-101	-236
Off-budget	175	189	193	205	32	85	21	65	24	90	14	69	25	96	14	74
Means of financing																
Borrowing	297	238	299	317	156	-75	44	121	179	-76	75	142	166	-86	96	153
Cash decrease	1	6	-5	0	28	-38	16	5	15	-25	0	10	15	-25	0	10
Other[2]	21	23	-7	-6	-1	16	-0	-1	6	-4	-8	-0	6	-4	-8	-0
Cash operating balance, end of period	36	30	35	35	8	46	30	25	10	35	35	25	10	35	35	25
					Seasonally adjusted annual rates											
NIPA federal sector																
Receipts	2174	2489	2621	2731	2491	2560	2555	2580	2611	2634	2661	2690	2713	2746	2777	2808
Expenditures	2509	2672	2843	2998	2638	2687	2749	2776	2833	2865	2898	2938	2992	3018	3044	3079
Consumption expenditures	758	798	844	881	804	803	816	822	843	852	859	865	881	886	891	896
Defense	509	535	570	597	538	538	547	553	569	577	582	587	597	601	604	607
Nondefense	249	264	274	284	266	265	269	269	274	275	277	278	284	286	287	289
Other spending	1751	1873	1999	2117	1834	1884	1933	1954	1990	2013	2039	2073	2111	2132	2153	2184
Current account surplus	-335	-183	-222	-267	-147	-127	-194	-196	-222	-231	-237	-248	-279	-273	-267	-272
Gross investment	107	118	124	127	118	117	120	121	123	125	126	126	127	127	127	127
Gross saving less gross investment[3]	-344	-198	-238	-280	-163	-141	-209	-212	-238	-247	-253	-263	-293	-286	-279	-283
Fiscal indicators[4]																
High-employment (HEB) surplus/deficit	-336	-218	-243	-263	-188	-171	-233	-229	-246	-248	-247	-251	-276	-267	-259	-262
Change in HEB, percent of potential GDP	-0.3	-1.1	0.1	0.1	-0.8	-0.1	0.4	-0.0	0.1	-0.0	-0.0	0.0	0.2	-0.1	-0.1	-0.0
Fiscal impetus (FI) percent of GDP	0.2	0.4	0.3	0.0	0.2	-0.0	0.1	0.0	0.2	0.0	-0.0	0.0	0.0	0.0	0.0	0.0
Previous	*0.2*	*0.4*	*0.3*	*n.a.*	*0.2*	*0.0*	*0.1*	*0.1*	*0.2*	*0.0*	*-0.0*	*0.0*	*n.a.*	*n.a.*	*n.a.*	*n.a.*

1. 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

Change in Debt of the Domestic Nonfinancial Sectors

(Percent)

Period[1]	Total	Households			Business	State and local governments	Federal government	Memo: Nominal GDP
		Total	Home mortgages	Consumer credit				
Year								
2001	6.3	9.4	10.1	8.9	6.0	8.8	-.2	2.7
2002	7.2	10.6	12.9	5.7	2.5	11.0	7.6	3.6
2003	8.2	11.6	14.3	5.2	2.6	8.3	10.9	5.9
2004	8.9	11.6	14.1	5.4	5.9	7.4	9.0	6.7
2005	9.5	11.7	13.8	4.0	7.7	10.2	7.0	6.4
2006	7.5	8.3	8.9	4.7	8.2	5.4	5.2	5.7
2007	6.5	6.3	7.0	4.0	7.1	4.2	6.4	4.7
2008	6.1	5.9	6.5	3.8	6.7	4.3	6.2	4.9
Quarter								
2006:1	9.5	9.6	10.8	2.5	9.6	3.5	11.3	9.0
2	6.4	9.0	9.0	6.6	7.5	6.6	-2.4	6.3
3	6.5	7.1	7.7	4.9	7.5	6.4	3.5	4.0
4	6.9	6.6	7.2	4.5	7.1	4.7	8.2	3.7
2007:1	7.6	6.4	7.0	4.1	7.2	4.2	12.7	4.6
2	4.8	6.3	6.9	4.1	7.0	4.2	-2.5	4.9
3	6.2	6.1	6.7	3.9	7.0	4.1	5.6	4.8
4	6.6	5.9	6.5	3.9	6.6	4.1	9.5	4.6
2008:1	6.8	5.9	6.5	3.7	6.5	4.3	10.9	4.9
2	4.4	5.8	6.4	3.7	6.6	4.2	-3.1	5.1
3	6.1	5.8	6.3	3.7	6.6	4.2	6.8	4.9
4	6.6	5.8	6.3	3.8	6.6	4.1	9.7	4.8

Note. Quarterly data are at seasonally adjusted annual rates.

1. Data after 2006:Q2 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

Flow of Funds Projections: Highlights
(Billions of dollars at seasonally adjusted annual rates except as noted)

Category	2005	2006	2007	2008	2006 Q3	2006 Q4	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
Domestic nonfinancial sectors														
Net funds raised														
Total	1949.7	1484.8	1585.6	1628.3	1266.1	1520.1	1889.6	1150.0	1558.3	1744.4	1842.0	1129.6	1677.0	1864.7
Net equity issuance	-363.6	-519.8	-262.4	-236.0	-544.0	-422.4	-282.4	-262.4	-262.4	-242.4	-236.0	-236.0	-236.0	-236.0
Net debt issuance	2313.3	2004.6	1848.0	1864.3	1810.1	1942.5	2172.0	1412.4	1820.7	1986.8	2078.0	1365.6	1913.0	2100.7
Borrowing indicators														
Debt (percent of GDP) [1]	204.6	208.6	213.5	216.4	209.4	211.0	212.5	213.2	213.6	214.6	215.6	216.0	216.2	217.1
Borrowing (percent of GDP)	18.6	15.1	13.3	12.8	13.6	14.4	16.0	10.3	13.1	14.1	14.6	9.5	13.1	14.2
Households														
Net borrowing [2]	1241.5	984.3	808.5	806.5	877.6	829.0	814.4	815.5	807.3	797.0	799.2	801.0	806.8	819.1
Home mortgages	1080.0	793.9	672.9	672.9	720.3	682.4	677.7	677.7	672.9	663.5	668.2	668.2	672.9	682.4
Consumer credit	89.0	109.1	98.3	96.3	115.8	108.4	98.9	100.4	97.3	96.5	93.9	95.5	96.4	99.2
Debt/DPI (percent) [3]	123.9	128.4	129.9	130.3	129.3	129.8	129.7	130.0	130.0	130.1	130.0	130.2	130.4	130.6
Business														
Financing gap [4]	-138.6	35.4	140.7	222.6	40.0	75.1	117.8	132.8	141.8	170.4	209.5	212.1	218.1	250.6
Net equity issuance	-363.6	-519.8	-262.4	-236.0	-544.0	-422.4	-282.4	-262.4	-262.4	-242.4	-236.0	-236.0	-236.0	-236.0
Credit market borrowing	593.4	675.6	638.7	645.3	644.2	626.8	647.0	640.2	648.2	619.2	619.7	644.8	652.7	663.9
State and local governments														
Net borrowing	171.5	100.1	82.8	86.8	121.5	90.5	82.8	82.8	82.8	82.8	86.8	86.8	86.8	86.8
Current surplus [5]	203.8	202.8	198.4	203.5	183.1	197.7	197.8	201.9	195.5	198.3	202.1	206.8	201.5	203.3
Federal government														
Net borrowing	306.9	244.6	318.0	325.8	166.8	396.2	627.9	-126.1	282.4	487.8	572.3	-167.0	366.8	530.9
Net borrowing (n.s.a.)	306.9	244.6	318.0	325.8	45.1	118.2	180.2	-77.3	73.9	141.1	166.3	-87.5	95.1	151.9
Unified deficit (n.s.a.)	319.7	269.8	310.4	318.6	59.2	123.4	200.5	-106.7	65.6	151.0	186.6	-116.5	86.7	161.8
Depository institutions														
Funds supplied	814.2	740.2	517.0	408.0	619.7	326.3	624.1	539.3	559.4	345.1	397.5	417.0	433.5	384.0

Note. Data after 2006:Q2 are staff projections.
1. Average debt levels in the period (computed as the average of period-end debt positions) divided by nominal GDP.
2. Includes change in liabilities not shown in home mortgages and consumer credit.
3. Average debt levels in the period (computed as the average of period-end debt positions) divided by disposable personal income.
4. For corporations, excess of capital expenditures over U.S. internal funds.
5. NIPA state and local government saving plus consumption of fixed capital and net capital transfers.
n.s.a. Not seasonally adjusted.

2.6.4 FOF

(This page intentionally blank.)

International Developments

The most important new element in the outlook is the marked decline in oil prices. The spot price of West Texas intermediate crude oil has declined more than $11 per barrel since the time of the August Greenbook. This decline apparently reflects improved prospects for oil supply. Although prices of many other primary commodities have moved down in the past week, non-fuel commodity prices on average are little changed over the intermeeting period.

Recent data have confirmed that growth of foreign output slowed moderately in the second quarter from its very rapid first-quarter pace and have pointed to a further slowing in the current quarter. We project that foreign real GDP growth will remain around a solid pace of 3¼ percent next year and in 2008. This forecast is little changed from the one in the August Greenbook, as the positive effects of lower oil prices are offset by reduced growth of demand from the United States. The path for foreign consumer price inflation is somewhat lower than previously projected, largely because of the recent decline in oil prices. With resource utilization in the major foreign economies generally near historical norms and with GDP growth projected to be in line with potential, inflation abroad is projected to remain contained over the forecast period.

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

Indicator	2005	2006: H1	Projection			
			2006		2007	2008
			Q3	Q4		
Foreign output	3.7	4.3	3.3	3.3	3.2	3.3
August GB	3.7	4.1	3.4	3.3	3.2	. . .
Foreign CPI	2.2	2.3	2.4	2.3	2.3	2.2
August GB	2.3	2.4	3.0	2.7	2.5	. . .

NOTE. Changes for years are measured as Q4/Q4; for half-years, Q2/Q4 or Q4/Q2.
. . . Not applicable.

The foreign exchange value of the dollar was little changed over the intermeeting period. Going forward, we continue to project a modest decline in the broad real dollar. Since the last FOMC meeting, long-term interest rates have declined 10 to 25 basis points in major foreign countries, share prices have increased moderately, and risk spreads on emerging-market debt have remained low.

Real net exports made a positive arithmetic contribution of nearly ½ percentage point at an annual rate to U.S. GDP growth in the second quarter and are expected to exert a roughly neutral influence in the third and fourth quarters, as the growth of imports rebounds but remains well below the growth of exports. Thereafter, real net exports are expected to subtract just 0.1 percentage point from GDP growth in 2007 and 0.3 percentage point in 2008, as real import growth continues to strengthen.

We project that the current account deficit will widen from its estimated second-quarter level of $860 billion at an annual rate, or 6.5 percent of GDP, to over $1 trillion (7 percent of GDP) in 2008. The deterioration of the current account balance is largely due to a decline in the net investment income balance, although the trade deficit continues to widen as well. Compared with the previous Greenbook, the current account deficit is roughly $40 billion narrower during the forecast period, mainly reflecting lower oil prices.

Oil Prices

The spot price of West Texas intermediate (WTI) crude oil closed at $63.77 per barrel on September 12, down more than $11 since the time of the August Greenbook. It is down more than $13 from its August 7 peak, which followed news that BP would have to shut down the Prudhoe Bay oil field. Over the intermeeting period, prices of crude oil futures contracts have also moved lower. The price of the contract for delivery in December 2012 closed at $62.90 per barrel on September 12, down more than $7 since the August Greenbook.

The decrease in the spot price appears to reflect the cease-fire between Hezbollah and Israel and indications that this year's hurricane season will be less active than previously feared. In addition, the market has come to believe that action against Iran, which continues to defy a U.N. resolution calling for the country to end its uranium enrichment activities, is not imminent. These factors have diminished the perceived risk of supply disruptions in the near term. BP's announcement on August 10 that it would be able to maintain at least partial production in Alaska also led prices to move down.

Despite their recent decline, oil prices remain elevated, reflecting supply disruptions and risks thereof. Significant amounts of Nigerian production remain shut in because of a lack of security, and increased violence in Iraq has put future production there at greater risk. In addition, to defend prices of its heavier crude oils and limit the growth in global crude inventories, Saudi Arabia has reduced production about 200,000 barrels per day from its first-quarter average.

Oil demand, particularly in developing countries, is expected to remain solid, contributing to a tight global oil market. Currently, spare production capacity only amounts to about 2 percent of global oil consumption and is expected to expand only gradually as a host of political and economic factors continue to hinder investment by oil companies.

Our oil price projection, which is based on NYMEX futures prices as of September 12, calls for the spot price of WTI to rise to $70 per barrel by the fourth quarter of 2007 and to remain near that level through the end of the forecast period. Compared with the August Greenbook forecast, the current projection averages $12 per barrel lower in the fourth quarter of this year and nearly $10 lower in 2007. The projected path of the oil import price has been revised down a similar amount. Given recent large movements in oil price quotes, considerable risks attend this projection.

International Financial Markets

The broad nominal trade-weighted foreign exchange value of the dollar rose slightly on balance over the intermeeting period, as the dollar appreciated 1¼ percent against the major foreign currencies but was unchanged against the currencies of the other important trading partners of the United States. On a bilateral basis, the dollar appreciated 2¼ percent against the yen, 1¾ percent versus sterling and 1¼ percent vis-à-vis the euro, but its exchange value against the Canadian dollar moved little on net. The dollar's fluctuations against the Latin American and East Asian emerging market currencies were small over the period.

On the basis of these developments and revised projections for U.S. and foreign inflation, the fourth-quarter starting point for the projected path of the broad real dollar is unchanged from the previous forecast. Further out, we project that the broad real dollar will depreciate at an average annual rate of 1¼ percent over the forecast period. This rate is slightly slower than the pace projected in the previous Greenbook, partly because we anticipate that market expectations of U.S. interest rates will rise toward the staff's financial assumptions. The downward trajectory for the dollar reflects our view that concerns about the rising U.S. current account deficit should weigh on the willingness of foreign investors to continue accumulating dollar-denominated assets at unchanged exchange rates.

For most industrial countries, news during the intermeeting period on inflation generally came in below market expectations, and nominal benchmark bond yields declined 10 basis points in Europe and Japan and 25 basis points in Canada. Long-term real bond yields generally moved little, implying that most of the downward movement in nominal rates reflected lower long-term inflation expectations. The exception was the United Kingdom, where inflation news was less favorable and real yields fell in tandem with nominal yields.

Share prices in the foreign industrial economies generally posted moderate increases, as the positive impetus imparted by declines in interest rates and falling energy prices outweighed the effects of concerns about future declines in growth. Headline indexes rose 4 percent in the euro area and 1½ percent in Japan and the United Kingdom, but they declined about 2 percent in Canada, a net oil exporter. Share prices also rose in many important emerging market economies, with the exception of Brazil, where prices fell 4 percent. The EMBI+ spreads for Mexico and Brazil recorded only small changes on net. The declaration by Mexico's electoral court in early September that Felipe Calderon had won the closely contested July 3 presidential election had been widely anticipated and had little effect on Mexican financial indicators.

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

Advanced Foreign Economies

We forecast that real GDP in the advanced foreign economies will rise 2½ percent at an annual rate in the final two quarters of this year, after having slowed to that pace in the second quarter. Subsequently, we expect GDP growth to edge down further to an average pace of around 2¼ percent over the rest of the forecast period, as slower U.S. growth and past and expected future monetary tightening weigh on foreign activity. The average four-quarter change in consumer prices is expected to run at just under 2 percent through early 2007, a slightly slower pace than in the previous Greenbook, in part as a result of our lower outlook for oil prices. Inflation then edges down to 1½ percent for the rest of the forecast period.

In Japan, real GDP grew a surprisingly low 1 percent at an annual rate in the second quarter, with declines in residential investment, net exports, and government spending and a negative contribution from inventories. The third quarter appears to have had a weak start, but because underlying fundamentals—including labor markets, balance sheets, and expectations—remain strong, we expect GDP to expand 2¼ percent in the fourth quarter before decelerating toward the economy's potential growth rate over the remainder of the forecast period. Japanese consumer price inflation is expected to be lower than previously projected over the forecast period, at about ½ percent, because of lower energy prices and the recent updating of the consumption basket in the price index. The revision to the index subtracted about ½ percentage point from measured inflation in the past year. We assume that the BoJ will increase its policy interest rate gradually from the current rate of 0.25 percent to 1.5 percent by the end of the forecast period.

Euro-area real GDP rose 3.6 percent in the second quarter, the fastest pace in six years. Although we do not expect growth to remain at such a rapid pace, recent strength in a number of economic indicators has prompted us to boost our forecast for current-quarter GDP growth ½ percentage point to 2½ percent. We expect growth to slow further to 1¾ percent by the second half of 2007, in part as a result of tightening monetary and fiscal policies, including a planned increase in the value-added tax (VAT) in Germany. With oil prices having declined from recent peaks and projected to move up only modestly going forward, we forecast that inflation will edge below 2 percent by 2008; the scheduled increase in the German VAT should interrupt this decline in inflation temporarily. Partly because of statements that ECB policymakers will exercise "strong vigilance" with respect to inflation, we assume that the ECB will raise its official interest rates a further 50 basis points, to 3.5 percent, later this year.

GDP growth in Canada stepped down from 3.6 percent in the first quarter to 2 percent in the second quarter. Growth of final domestic demand stayed strong and inventory accumulation also boosted growth, but the trade balance deteriorated sharply. In the near term, lower U.S. growth as well as a slower rate of inventory accumulation will keep Canadian GDP growth at moderate rates. Growth then edges up over the remainder of the forecast period in line with the contour of the U.S. forecast. The twelve-month rate of consumer price inflation, which declined to 2.3 percent in July, should fall below 2 percent in 2007, reflecting our projection for energy prices. We assume that the Bank of Canada will keep monetary policy on hold for the foreseeable future.

In the United Kingdom, real GDP rose 3.1 percent at an annual rate in the second quarter, about the same as in the first quarter; however, the pace of domestic demand growth picked up considerably. Recent data on activity for the third quarter are softer than those in the second, and we project U.K. real GDP growth to slow a bit going forward. The twelve-month rate of CPI inflation was 2.5 percent in August. We expect inflation to remain elevated over the next few quarters, held up by the run-up in energy prices earlier this year and a one-time hike in university fees, before falling below the Monetary Policy Committee's 2 percent target in 2008. Given the concerns over inflation expressed in the *Inflation Report* and the minutes from the most recent policy meeting, we assume that the MPC will hike policy rates a further 25 basis points by the end of this year.

Emerging Market Economies

Real GDP growth in the emerging-market economies is estimated to have moderated from 6¾ percent at an annual rate in the first quarter to 5¾ percent in the second. The decline was somewhat smaller than we had projected in the August Greenbook, mainly because incoming data from Latin America have generally surprised on the upside. Going forward, growth is expected to moderate further to just over 4½ percent in the second half of this year and to stay at around this rate for the rest of the forecast period. The projection is little changed from the August Greenbook, as the net effects of the lower path of oil prices are roughly offset by the somewhat weaker outlook for the high-tech sector and for U.S. GDP growth. Notwithstanding some moderation, economic growth is still expected to be solid, continuing to be supported in many of these economies by high commodity prices as well as the strength of the Chinese economy.

China's growth averaged over 12 percent at an annual rate in the first half of this year. Investment growth remained higher than desired by the authorities, and the trade balance registered a record surplus in the second quarter. The latest monthly data are showing some tentative signs of moderation, with twelve-month growth in investment declining in July and August. The People's Bank of China raised benchmark interest rates again in mid-August. Chinese authorities appear to be more serious about enforcing direct and administrative controls put in place recently to slow investment and cool the economy. Authorities have also introduced further measures, including some to curb speculative real estate investment. As a result, we continue to project that Chinese growth will slow to 8¼ percent by next year.

Elsewhere in emerging Asia, GDP growth in Korea declined in the second quarter to 3½ percent, partly in response to tax and regulatory measures aimed at cooling the housing market, as well as to monetary policy tightening and currency appreciation over the past year. We expect Korean GDP growth to gradually increase to about 4½ percent by the end of 2008, as the effect of oil prices wanes, U.S. growth edges up, and global high-tech demand improves. For the rest of the region, GDP growth is expected to range from about 4 percent to 7 percent, with India and Malaysia at the high end of this range.

In Latin America, real GDP growth is estimated to have averaged 6 percent at an annual rate in the second quarter, down a bit from the first quarter but significantly higher than estimated in the previous Greenbook. Much of the upward surprise was due to rapid growth in Mexico, reflecting strong manufacturing activity, a boom in construction, and solid agricultural production. GDP growth in Mexico is expected to shift down to 3¼ percent over the forecast period, consistent with the outlook for U.S. manufacturing production. In South America, GDP growth is expected to shift down from about 5¼ percent in the second quarter to 4 percent for the forecast period in response to a levelling-off of commodity prices and lower growth in both the United States and China. The Brazilian outlook has been marked down a bit in response to weaker-than-expected incoming data.

Twelve-month inflation in emerging-market economies is expected to pick up a little in the near term to 3¼ percent, as adjustments to previous increases in energy prices take place, and then to edge back down to 3 percent in 2008. The outlook is somewhat lower than the one in the last Greenbook, mainly because of the effect of the downward revision to the oil price path.

Prices of Internationally Traded Goods

We project that core import prices, after increasing at an annual rate of 3¾ percent in the second quarter, will increase 4 percent at an annual rate in the third quarter. This elevated pace reflects the continued effects of higher nonfuel commodity prices and the depreciation of the dollar that occurred earlier this year. Our third-quarter projection is down almost ½ percentage point from the August Greenbook because core import prices in July were weaker than expected.

Core import prices are projected to begin decelerating in the fourth quarter. Consistent with futures markets, we expect nonfuel commodity prices to remain about flat, with their earlier increases providing diminishing impetus to import prices over the next several quarters. By the end of 2007, with commodity prices having leveled off and the dollar depreciating only gradually, core import price inflation is projected to drop to an annual rate of about 1 percent. We project that, absent additional shocks, core import price inflation will remain about 1 percent in 2008. Our projection of core import price inflation beyond the current quarter is very close to that in the August Greenbook, as our projections for commodity prices and the dollar have not changed enough to materially affect the price outlook.

Staff Projections of Selected Trade Prices
(Percent change from end of previous period excepted as noted; s.a.a.r.)

Trade category	2005	2006: H1	Projection 2006 Q3	Projection 2006 Q4	Projection 2007	Projection 2008
Exports						
Core goods	3.9	5.2	6.3	3.2	2.2	1.1
August GB	3.9	5.2	7.9	3.7	1.8	. . .
Imports						
Non-oil core goods	2.2	2.7	3.9	3.2	1.4	1.0
August GB	2.2	2.6	4.3	3.4	1.4	. . .
Oil price (dollars per barrel)	55.39	63.75	65.37	59.10	64.81	64.32
August GB	55.39	63.69	67.52	70.65	73.42	. . .

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 multiquarter periods is the price for the final quarter of the period. Imported oil includes both crude oil and refined products.

. . . Not applicable.

Core export prices increased at an annual rate of 6¾ percent in the second quarter. This rise was concentrated in prices of exported industrial supplies, which increased at an annual rate of nearly 17 percent. In July, core export prices moved up solidly but a bit more slowly than in the past several months, reflecting some moderation of the high rate of inflation in exported material-intensive goods. In the current quarter, core export prices are expected to continue rising rapidly because of the recent strength of intermediate materials prices and prices for primary commodities (especially metals). Thereafter, core export price inflation is expected to decline, as prices for intermediate materials and primary commodities level off. Compared with the previous Greenbook, the projected rate of core export price inflation in the current quarter is 1½ percentage points lower because of lower projected prices for petroleum products and the weaker-than-expected export price inflation reported in July. In subsequent quarters, the forecast is not much changed.

Trade in Goods and Services

We project that real net exports will make a neutral contribution to the growth of U.S. GDP in the third quarter, following a positive contribution in the second quarter, as import growth picks up and export growth slows from its second-quarter pace. The contribution of real net exports remains slightly negative on balance for the remainder of the forecast period, subtracting 0.1 percentage point from real GDP growth in 2007 and 0.3 percentage point in 2008. Although import growth remains below export growth until late in the period, the higher initial level of imports results in a deterioration of net exports. Compared with the August Greenbook, the contribution of net exports has been revised down 0.3 percentage point in the third quarter, reflecting surprisingly strong nominal import data for July and an upward revision to our projection for oil imports in light of the problems with the Prudhoe Bay pipeline. For 2007, the projected contribution is unchanged.

Incoming data on trade showed relatively strong nominal imports of goods and services in June, but growth of real imports of goods and services for the second quarter as a whole fell sharply to only 1½ percent at an annual rate from 9 percent in the first quarter. In July, imports rose further, and we expect growth of real imports of goods and services to rise to 3¼ percent in the current quarter—up nearly 1½ percentage points from the previous Greenbook—and to step up a bit further in the fourth quarter. Imports of core goods, which had slowed substantially in the second quarter, are projected to pick up in the second half of this year to a pace more in line with the evolution of U.S. income and relative prices. Imports of oil in real terms are expected to ease somewhat in the third quarter before rising sharply in the fourth quarter; much of this pattern reflects the BEA's quirky seasonal factors. Imports of computers and semiconductors should post robust real growth over the second half of the year, with imports of semiconductors picking up from an unusually slow pace of growth in the first half. The acceleration of goods imports this quarter and next more than offsets a deceleration of imported services.

Beyond this year, import growth is projected to continue strengthening. Growth of core imports is supported by the edging up of U.S. GDP growth and deceleration of core import prices. Imports of services are expected to grow more slowly than imports of core goods because of the relatively higher price inflation in services imports. Growth of imports of computers and semiconductors is expected to remain relatively strong during the forecast period. Since the August Greenbook, our projection for real import growth beyond the current quarter is slightly lower, in large part reflecting the modest downward revision to U.S. GDP growth.

The June data showed strong growth in nominal exports, but real exports of goods and services for the second quarter as a whole decelerated to about 6¼ percent at an annual rate from the elevated 14 percent pace in the first quarter. In July, exports fell back a bit from the elevated June level, primarily reflecting a reduction in exports of capital goods, including aircraft. We project that growth of real exports of goods and services will edge down to 4¾ percent in the current quarter and will remain close to that pace in the fourth quarter. The growth of core goods and services exports should ease somewhat in the second half of the year, primarily reflecting the step down in the growth of foreign activity. Growth of semiconductor exports is projected to slow from a very rapid first half pace, while growth of computer exports should remain steady.

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

Indicator	2005	2006: H1	Projection			
			2006		2007	2008
			Q3	Q4		
Real exports	6.7	10.1	4.7	4.9	4.6	5.1
August GB	6.7	8.8	5.6	5.1	5.1	. . .
Real imports	5.2	5.2	3.2	3.8	3.7	5.3
August GB	5.2	4.7	1.8	4.4	4.0	. . .

NOTE. Changes for years are measured as Q4/Q4; for half-years, Q2/Q4 or Q4/Q2.
. . . Not applicable.

We project that growth of real exports of goods and services will remain close to its second-half pace next year before moving up in 2008. Core export growth slows from 7½ percent in 2006 to 3¼ percent in 2007, reflecting, among other factors, a deceleration of foreign growth and some effects of the dollar's appreciation in 2005. Core export growth then picks up a bit in 2008 as relative prices become more favorable, reflecting the renewed depreciation of the dollar and the deceleration of core export prices. Exports of services are expected to remain close to their current pace through the end of the forecast period, and exports of computers and semiconductors are projected to continue to rise at a brisk pace. This forecast is a little lower than in the August Greenbook, reflecting the slower pace of dollar depreciation.

Alternative Simulations

In our baseline forecast, relatively strong growth in our major trading partners is expected to contribute to continued expansion in the United States and to help the U.S. trade deficit to stabilize as a share of GDP over the forecast period. However, foreign activity may expand less robustly than projected. To assess the implications of such a development, our first alternative simulation uses the FRB/Global model to examine the effects of a broad-based weakening in consumption and investment demand in major U.S. trading partners. While this shock causes some endogenous depreciation of foreign currencies against the dollar, we also considered a second scenario that intensifies the magnitude of foreign currency depreciation by incorporating additional risk premium shocks.

In the first scenario, the shock is calibrated so that consumption and investment spending would decline 1 percent per year relative to the baseline in foreign industrial countries and 2 percent per year in emerging markets in the absence of endogenous adjustment of interest rates. The shock begins in 2006:Q4. The fall in foreign activity reduces U.S. real net exports directly through weaker foreign spending and indirectly through a modest appreciation of the dollar. As a result, U.S. GDP growth declines 0.2 percentage point relative to baseline next year and about 0.1 percentage point in 2008. The decline in output relative to baseline is cushioned by a substantial policy response, with the federal funds rate falling about 1 percentage point below baseline by the end of the forecast period. Core PCE inflation declines nearly 0.2 percentage point below baseline in both 2007 and 2008. The fall in core PCE prices reflects several factors, including lower import prices due to dollar appreciation, the effects of the contraction in aggregate demand on domestic prices, and lower oil prices due to the fall in world demand. The combination of weaker foreign activity and an appreciated dollar contributes to a noticeable deterioration of the trade balance of 0.3 percentage point of GDP by the end of the forecast period.

In the second scenario, the foreign demand shock is accompanied by additional risk-premium shocks that induce the broad real dollar to appreciate about 11 percent by the end of the forecast period (compared with about 4 percent in the first scenario). The larger appreciation of the dollar induces a more-pronounced reduction in U.S. GDP growth relative to baseline than in the first scenario, with U.S. output growth falling around ¾ percentage point below baseline in 2007. Core PCE inflation also falls noticeably more than in the first scenario. Finally, the combined shocks contribute to a sizable deterioration of the trade balance of about ¾ percentage point of GDP by the end of the forecast period.

Alternative Simulations:
Weaker Foreign Demand and Dollar Appreciation
(Percent change from previous period, annual rate)

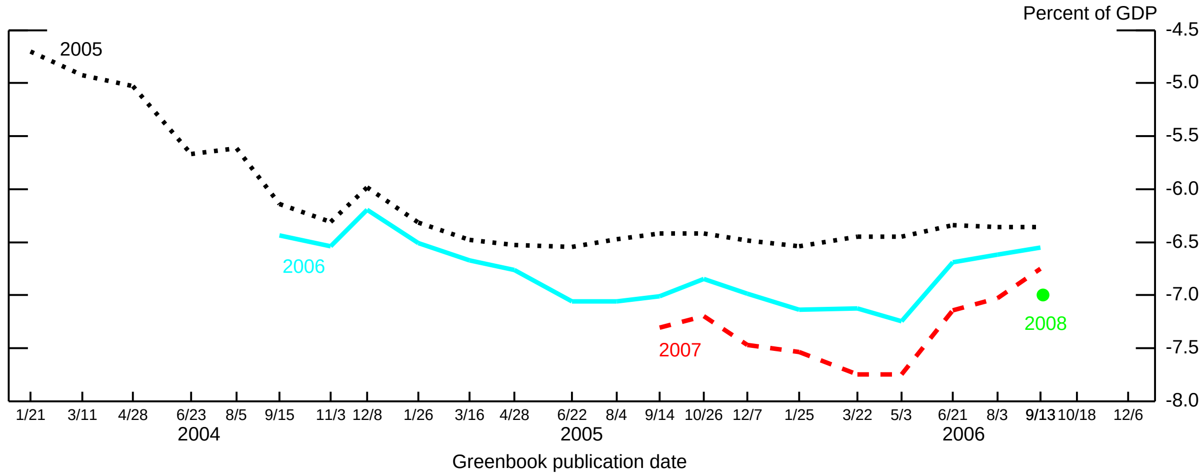
Indicator and simulation	2006		2007		2008	
	H1	H2	H1	H2	H1	H2
U.S. real GDP						
Baseline	4.2	1.7	2.0	2.2	2.4	2.5
Weaker foreign demand	4.2	1.6	1.8	2.0	2.2	2.4
Additional dollar appreciation	4.2	1.6	1.2	1.6	2.1	2.7
U.S. PCE prices excluding food and energy						
Baseline	2.5	2.4	2.4	2.3	2.2	2.1
Weaker foreign demand	2.5	2.4	2.3	2.1	1.9	1.9
Additional dollar appreciation	2.5	2.2	2.2	2.0	1.9	1.8
U.S. Trade Balance (percent of GDP)						
Baseline	-5.9	-5.7	-5.7	-5.6	-5.7	-5.6
Weaker foreign demand	-5.9	-5.6	-5.5	-5.5	-5.8	-5.9
Additional dollar appreciation	-5.9	-5.4	-5.5	-5.7	-6.2	-6.3

Note. H1 is Q2/Q4; H2 is Q4/Q2. The federal funds rate is adjusted according to a Taylor rule.

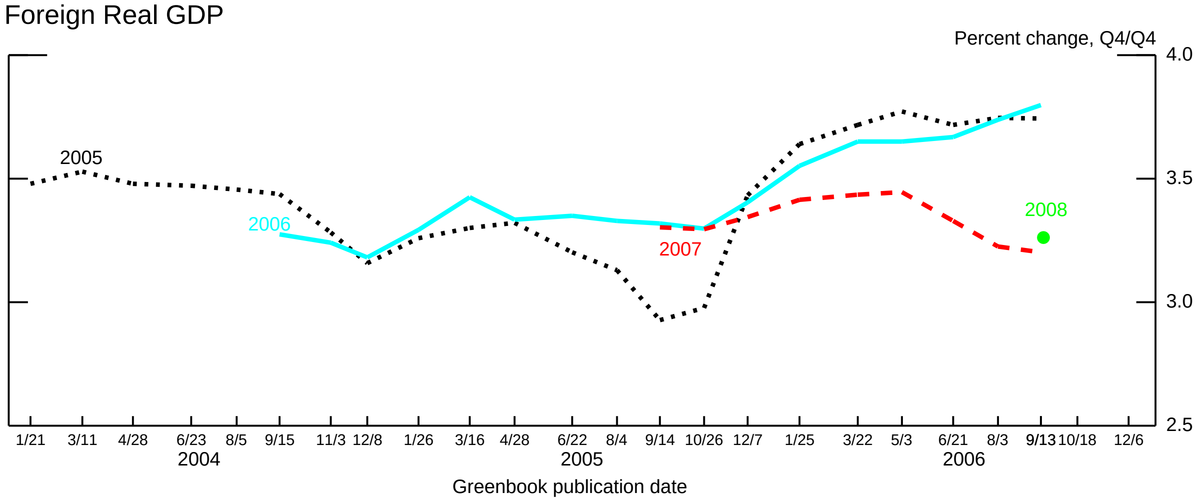
Class II FOMC -- Restricted (FR)

Evolution of the Staff Forecast

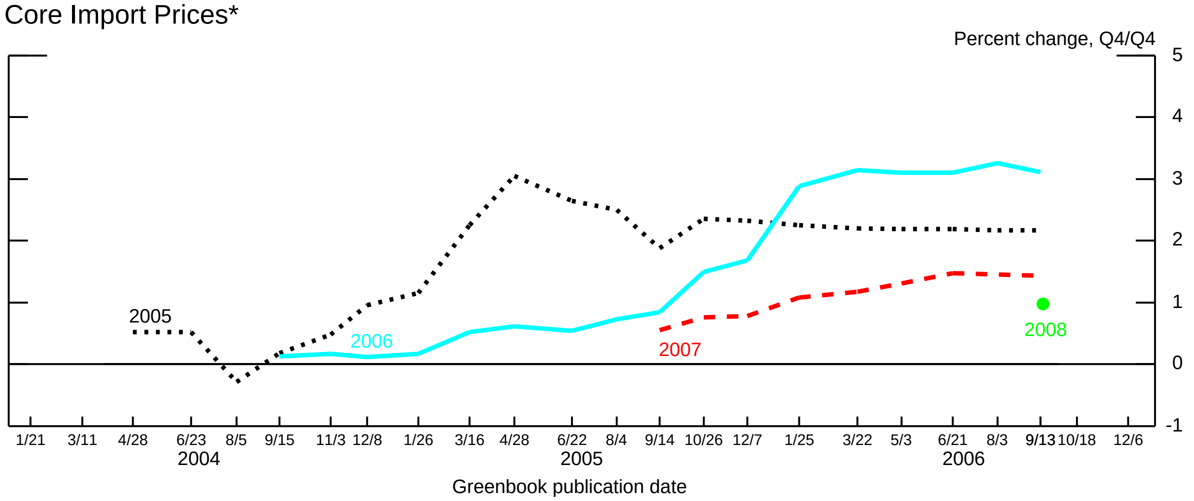
Current Account Balance



Foreign Real GDP



Core Import Prices*



*Prices for merchandise imports excluding computers, semiconductors, oil, and natural gas.

Class II FOMC
Restricted (FR)

September 13, 2006

OUTLOOK FOR FOREIGN REAL GDP AND CONSUMER PRICES: SELECTED COUNTRIES
(Percent, Q4 to Q4)

Measure and country	2000	2001	2002	2003	2004	2005	2006 (Projected)	2007 (Projected)	2008 (Projected)
REAL GDP (1)									
Total foreign	4.2	0.4	3.1	3.0	3.8	3.7	3.8	3.2	3.3
Industrial Countries	3.6	0.9	2.5	1.8	2.5	2.7	2.6	2.2	2.3
of which:									
Canada	4.1	1.3	3.5	1.5	3.7	2.8	2.6	2.5	2.7
Japan	3.4	-1.5	2.0	2.6	0.5	4.0	2.0	1.8	1.5
United Kingdom	3.1	2.0	2.3	3.3	2.6	1.8	2.9	2.5	2.4
Euro Area (2)	3.3	1.0	1.1	1.0	1.5	1.8	2.9	1.6	1.7
Germany	2.3	1.1	0.0	0.2	0.2	1.7	2.8	0.9	1.5
Developing Countries	5.2	-0.4	3.9	4.7	5.7	5.3	5.4	4.6	4.6
Asia	5.8	1.1	6.3	6.9	6.1	7.2	6.1	5.7	5.8
Korea	4.3	4.7	7.8	4.2	2.9	5.3	4.0	4.2	4.4
China	8.2	7.8	9.2	10.5	10.1	9.9	10.9	8.3	8.2
Latin America	4.4	-1.3	1.6	2.3	5.2	3.1	4.8	3.5	3.4
Mexico	4.8	-1.3	2.0	2.0	4.8	2.7	4.8	3.3	3.3
Brazil	3.8	-1.0	4.1	0.9	4.8	1.5	3.4	3.2	3.2
CONSUMER PRICES (3)									
Industrial Countries	1.8	0.9	2.1	1.3	1.8	1.5	1.8	1.6	1.5
of which:									
Canada	3.1	1.1	3.8	1.7	2.3	2.3	2.3	1.8	2.0
Japan	-0.8	-1.1	-0.5	-0.4	0.5	-1.0	0.6	0.5	0.6
United Kingdom (4)	0.9	1.1	1.5	1.3	1.4	2.1	2.5	2.0	1.7
Euro Area (2)	2.5	2.1	2.3	2.0	2.3	2.3	2.0	2.0	1.6
Germany	1.7	1.4	1.2	1.1	2.1	2.2	1.4	2.5	1.4
Developing Countries	4.1	2.8	2.9	3.1	3.9	3.1	2.9	3.2	3.0
Asia	1.8	1.2	0.8	2.2	3.2	2.6	2.5	2.8	2.6
Korea	2.5	3.3	3.4	3.5	3.4	2.5	3.5	3.1	2.4
China	1.0	-0.1	-0.5	2.7	3.3	1.4	2.0	2.6	2.3
Latin America	8.4	5.3	6.4	4.9	5.7	3.8	3.8	3.8	3.7
Mexico	8.7	5.1	5.2	3.9	5.3	3.1	3.5	3.5	3.5
Brazil	6.4	7.5	10.7	11.5	7.2	6.1	3.2	3.7	3.7

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.

Class II FOMC
Restricted (FR)

September 13, 2006

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

Measure and country	2006 Q1	2006 Q2	2006 Q3	2006 Q4	Projected 2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
REAL GDP (1)	Quarterly changes at an annual rate											
Total foreign	4.7	3.9	3.3	3.3	3.2	3.2	3.2	3.2	3.2	3.3	3.3	3.3
Industrial Countries	3.2	2.5	2.4	2.4	2.1	2.2	2.2	2.3	2.3	2.3	2.3	2.3
of which:												
Canada	3.6	2.0	2.3	2.3	2.4	2.4	2.5	2.6	2.7	2.7	2.8	2.8
Japan	3.3	1.0	1.5	2.3	2.1	1.7	1.8	1.6	1.6	1.6	1.5	1.4
United Kingdom	3.0	3.1	2.8	2.7	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.4
Euro Area (2)	3.2	3.6	2.6	2.3	1.1	1.8	1.7	1.7	1.7	1.7	1.8	1.8
Germany	2.7	3.6	2.6	2.4	-0.7	1.5	1.4	1.5	1.4	1.5	1.5	1.5
Developing Countries	6.8	5.8	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Asia	7.4	5.3	5.7	5.8	5.7	5.7	5.7	5.7	5.7	5.8	5.8	5.8
Korea	4.9	3.4	3.9	3.9	4.1	4.2	4.2	4.2	4.3	4.4	4.5	4.5
China	13.3	11.7	9.5	9.0	8.5	8.2	8.2	8.2	8.2	8.2	8.2	8.2
Latin America	6.6	5.9	3.5	3.4	3.5	3.5	3.5	3.4	3.4	3.4	3.4	3.4
Mexico	6.6	6.1	3.3	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Brazil	5.2	1.8	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2
CONSUMER PRICES (3)	Four-quarter changes											
Industrial Countries	1.8	2.0	1.8	1.8	1.9	1.7	1.5	1.6	1.5	1.5	1.5	1.5
of which:												
Canada	2.5	2.6	2.3	2.3	2.2	1.9	1.7	1.8	1.9	1.9	2.0	2.0
Japan	-0.1	0.2	0.4	0.6	0.3	0.4	0.4	0.5	0.5	0.5	0.6	0.6
United Kingdom (4)	2.0	2.2	2.4	2.5	2.6	2.3	1.9	2.0	1.8	1.8	1.8	1.7
Euro Area (2)	2.3	2.4	2.2	2.0	2.4	2.1	2.0	2.0	1.7	1.7	1.7	1.6
Germany	2.1	2.1	1.7	1.4	2.8	2.5	2.4	2.5	1.4	1.4	1.4	1.4
Developing Countries	3.1	3.0	2.8	2.9	3.2	3.2	3.3	3.2	3.1	3.0	3.0	3.0
Asia	2.4	2.6	2.3	2.5	3.0	2.9	3.0	2.8	2.7	2.6	2.6	2.6
Korea	2.4	2.3	2.7	3.5	4.0	4.2	3.7	3.1	2.7	2.5	2.4	2.4
China	1.2	1.4	1.3	2.0	2.5	2.5	2.8	2.6	2.4	2.3	2.3	2.3
Latin America	4.2	3.5	3.7	3.8	3.6	3.9	3.8	3.8	3.7	3.7	3.7	3.7
Mexico	3.7	3.1	3.3	3.5	3.3	3.6	3.5	3.5	3.5	3.5	3.5	3.5
Brazil	5.6	4.3	3.9	3.2	2.8	3.1	3.7	3.7	3.7	3.7	3.7	3.7

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.

Class II FOMC
Restricted (FR)

September 13, 2006

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	2000	2001	2002	2003	2004	2005	2006 (Projected)	2007 (Projected)	2008 (Projected)
NIPA REAL EXPORTS and IMPORTS									
Percentage point contribution to GDP growth, Q4/Q4									
Net Goods & Services	-0.9	-0.2	-0.9	-0.1	-0.8	-0.1	0.1	-0.1	-0.3
Exports of G&S	0.7	-1.3	0.4	0.6	0.7	0.7	0.8	0.5	0.6
Imports of G&S	-1.6	1.1	-1.3	-0.7	-1.5	-0.8	-0.7	-0.6	-0.9
Percentage change, Q4/Q4									
Exports of G&S	6.5	-11.9	3.8	5.8	7.0	6.7	7.4	4.6	5.1
Services	1.8	-8.9	10.2	3.0	7.1	3.1	5.8	5.2	5.0
Computers	22.7	-23.5	-1.1	11.3	6.4	14.1	11.7	14.4	14.4
Semiconductors	27.6	-34.6	10.1	38.3	-6.3	17.2	17.0	17.0	17.0
Other Goods 1/	5.9	-10.2	0.7	4.9	8.0	7.5	7.4	3.2	4.0
Imports of G&S	11.2	-7.6	9.7	4.8	10.6	5.2	4.4	3.7	5.3
Services	10.6	-5.9	8.8	2.2	7.6	1.9	5.5	2.8	3.4
Oil	13.3	3.7	3.8	1.2	9.6	0.9	-5.7	-1.5	1.7
Computers	13.9	-13.6	13.2	17.0	22.5	11.8	21.0	17.5	17.5
Semiconductors	22.8	-51.1	11.0	-0.1	9.3	7.5	8.3	17.0	17.0
Other Goods 2/	10.3	-6.5	10.0	5.2	10.7	6.2	5.5	3.9	5.6
Billions of Chained 2000 Dollars									
Net Goods & Services	-379.5	-399.1	-471.3	-518.9	-590.9	-619.2	-628.2	-630.6	-661.4
Exports of G&S	1096.3	1036.7	1013.3	1026.1	1120.4	1196.1	1295.2	1357.4	1422.7
Imports of G&S	1475.8	1435.8	1484.6	1545.0	1711.3	1815.3	1923.4	1988.0	2084.2
Billions of dollars									
US CURRENT ACCOUNT BALANCE	-415.2	-389.0	-472.4	-527.5	-665.3	-791.5	-868.1	-934.8	-1010.4
Current Acct as Percent of GDP	-4.2	-3.8	-4.5	-4.8	-5.7	-6.4	-6.5	-6.7	-7.0
Net Goods & Services (BOP)	-377.6	-362.8	-421.1	-494.9	-611.3	-716.7	-769.9	-785.7	-821.2
Investment Income, Net	25.7	30.3	17.8	42.3	33.6	17.6	-4.9	-56.6	-95.5
Direct, Net	94.9	115.9	102.4	112.8	123.9	134.4	158.6	170.5	189.6
Portfolio, Net	-69.2	-85.5	-84.6	-70.5	-90.2	-116.8	-163.5	-227.0	-285.1
Other Income & Transfers,Net	-63.3	-56.5	-69.2	-74.9	-87.6	-92.4	-93.3	-92.5	-93.7

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

Class II FOMC
Restricted (FR)

September 13, 2006

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	2003				2004				2005			
	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	0.2	-0.7	0.5	-0.5	-0.7	-1.6	-0.2	-0.8	-0.2	0.7	-0.1	-1.1
Exports of G&S	-0.5	-0.2	1.0	1.8	0.7	0.6	0.5	1.0	0.5	0.9	0.3	1.0
Imports of G&S	0.7	-0.6	-0.5	-2.3	-1.4	-2.2	-0.7	-1.8	-0.6	-0.2	-0.4	-2.0
Percentage change from previous period, s.a.a.r.												
Exports of G&S	-5.3	-1.7	11.4	20.8	7.2	6.2	4.8	9.9	4.7	9.4	3.2	9.6
Services	-20.0	-2.8	17.5	23.1	7.5	5.6	-2.8	19.2	2.9	2.0	2.1	5.5
Computers	-2.3	-5.2	34.7	23.2	-5.8	-3.1	20.7	16.5	13.6	21.9	17.8	3.9
Semiconductors	37.4	30.9	44.6	40.7	11.5	-7.8	-19.1	-7.2	-7.7	21.3	26.3	33.6
Other Goods 1/	0.3	-2.9	5.1	18.2	7.6	8.1	9.7	6.4	5.8	11.9	1.8	10.7
Imports of G&S	-5.0	4.1	3.8	17.6	10.2	16.0	4.4	12.0	4.1	1.4	2.5	13.2
Services	-10.6	-15.7	21.2	19.6	10.9	7.6	3.1	9.0	-0.2	-1.5	1.2	8.3
Oil	-9.7	12.4	-6.0	9.9	37.2	-22.9	-6.4	45.5	7.0	-21.2	-12.5	40.5
Computers	11.4	10.7	11.1	36.9	21.1	30.2	27.5	11.9	9.2	9.4	19.6	9.3
Semiconductors	-6.3	1.1	-4.2	9.7	43.3	19.6	3.8	-19.9	-7.4	8.4	15.6	14.9
Other Goods 2/	-3.1	7.2	-0.1	18.1	5.3	23.2	4.2	11.0	4.4	5.8	2.7	12.3
Billions of Chained 2000 Dollars, s.a.a.r.												
Net Goods & Services	-507.2	-526.9	-513.8	-527.8	-548.5	-593.9	-599.4	-621.9	-626.4	-606.1	-607.6	-636.6
Exports of G&S	1003.3	999.0	1026.3	1075.8	1094.8	1111.3	1124.3	1151.3	1164.5	1191.0	1200.5	1228.4
Imports of G&S	1510.5	1525.9	1540.0	1603.6	1643.2	1705.2	1723.7	1773.1	1790.9	1797.1	1808.1	1865.0
Billions of dollars, s.a.a.r.												
US CURRENT ACCOUNT BALANCE	-548.7	-524.4	-526.2	-510.8	-583.3	-667.1	-665.3	-745.4	-766.9	-773.0	-733.7	-892.4
Current Account as % of GDP	-5.1	-4.8	-4.7	-4.6	-5.1	-5.7	-5.6	-6.2	-6.3	-6.3	-5.8	-7.0
Net Goods & Services (BOP)	-496.9	-492.9	-491.9	-497.9	-544.6	-605.6	-626.7	-668.3	-672.4	-688.2	-727.2	-779.1
Investment Income, Net	24.4	41.7	39.2	63.8	57.3	28.2	33.4	15.6	20.7	14.2	37.9	-2.3
Direct, Net	97.2	108.4	109.3	136.3	130.4	113.4	122.8	128.8	121.4	124.2	161.5	130.6
Portfolio, Net	-72.7	-66.6	-70.1	-72.5	-73.1	-85.2	-89.4	-113.2	-100.7	-110.0	-123.6	-132.9
Other Inc. & Transfers, Net	-76.2	-73.2	-73.5	-76.7	-96.1	-89.7	-72.0	-92.7	-115.1	-99.0	-44.3	-111.0

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

Class II FOMC
Restricted (FR)

September 13, 2006

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	Projected											
	2006				2007				2008			
	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	-0.0	0.4	-0.0	-0.1	-0.2	0.2	0.2	-0.6	-0.7	0.0	0.0	-0.7
Exports of G&S	1.4	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Imports of G&S	-1.5	-0.3	-0.5	-0.6	-0.8	-0.3	-0.3	-1.1	-1.2	-0.5	-0.6	-1.3
Percentage change from previous period, s.a.a.r.												
Exports of G&S	14.0	6.3	4.7	4.9	4.7	4.7	4.6	4.5	4.7	5.0	5.2	5.3
Services	6.7	6.5	5.0	5.1	4.8	5.2	5.3	5.2	5.0	5.0	5.0	5.0
Computers	9.8	12.0	8.2	17.0	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4
Semiconductors	15.7	30.6	6.1	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0
Other Goods 1/	17.8	4.6	4.3	3.6	3.4	3.4	3.1	3.0	3.4	3.9	4.2	4.4
Imports of G&S	9.1	1.5	3.2	3.8	4.5	2.0	2.0	6.4	7.1	3.1	3.4	7.8
Services	7.4	11.0	1.9	2.0	2.4	2.8	2.9	3.1	3.2	3.4	3.5	3.5
Oil	-4.8	-18.3	-5.0	7.0	11.5	-14.7	-15.5	16.9	21.9	-15.7	-13.4	20.4
Computers	34.3	16.9	16.2	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5
Semiconductors	3.6	-1.3	14.9	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0
Other Goods 2/	12.4	2.3	5.0	2.8	3.0	3.6	4.2	4.6	5.1	5.6	5.8	5.9
Billions of Chained 2000 Dollars, s.a.a.r.												
Net Goods & Services	-636.6	-624.3	-624.7	-627.2	-633.8	-627.9	-622.2	-638.3	-657.6	-656.1	-655.6	-676.4
Exports of G&S	1269.3	1288.8	1303.6	1319.3	1334.4	1349.9	1365.2	1380.3	1396.3	1413.3	1431.3	1450.1
Imports of G&S	1905.9	1913.1	1928.2	1946.4	1968.2	1977.7	1987.4	2018.7	2053.8	2069.4	2086.9	2126.4
Billions of dollars, s.a.a.r.												
US CURRENT ACCOUNT BALANCE	-836.3	-859.7	-884.0	-892.4	-920.5	-924.1	-926.0	-968.7	-996.5	-996.5	-1002.5	-1045.9
Current Account as % of GDP	-6.4	-6.5	-6.6	-6.6	-6.8	-6.7	-6.6	-6.9	-7.0	-6.9	-6.9	-7.1
Net Goods & Services (BOP)	-764.6	-775.3	-783.5	-756.2	-789.0	-781.5	-774.7	-797.5	-827.0	-814.8	-809.0	-833.8
Investment Income, Net	14.0	4.2	-3.8	-34.0	-42.6	-52.3	-59.3	-72.2	-77.5	-89.8	-101.5	-113.1
Direct, Net	155.6	162.1	165.2	151.6	160.7	167.1	176.4	177.5	185.6	187.9	191.1	193.9
Portfolio, Net	-141.6	-157.8	-169.0	-185.6	-203.3	-219.5	-235.7	-249.7	-263.2	-277.7	-292.7	-307.0
Other Inc. & Transfers, Net	-85.7	-88.6	-96.8	-102.1	-88.9	-90.3	-92.0	-99.0	-92.0	-92.0	-92.0	-99.0

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