Prefatory Note

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Strictly Confidential (FR) Class II FOMC

Part 1

January 26, 2005

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

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Domestic Developments

In broad terms, the outlook for economic activity and inflation in this forecast is much the same as we presented in the December Greenbook. Over the next two years, we are projecting that real GDP will rise at an average annual rate of 3¾ percent, gradually eliminating the remaining slack in resource utilization, while core PCE inflation will remain stable at an annual rate of about 1½ percent.

For the near term, the news on consumer spending, homebuilding, and motor vehicle production point to a somewhat higher level of economic activity in the first quarter than we had assumed, and we have raised our projected increase in real GDP in the current quarter to an annual rate of 3¾ percent. Beyond the near term, however, a number of the key conditioning factors are now slightly more restrictive than in the December Greenbook. All in all, the effect of these changes is small—shaving 0.1 percentage point from the level of real GDP by the end of 2006.

The recent favorable news on inflation has lent further support to our view that the underlying trend in core PCE inflation is running at an annual rate of about 1½ percent, and we continue to believe that inflation expectations are well anchored. In this forecast, higher energy prices boost overall consumer price inflation a bit in the near term, but the change is sufficiently small that its contribution to core inflation is imperceptible. As before, we anticipate that energy prices will decline over the course of the projection period and that the contribution of rising prices of imported goods to consumer price inflation will wane, providing offsets to the effects of diminishing economic slack and the faster rate of increase in trend unit labor costs.

Key Background Factors

This forecast is conditioned on a slightly tighter stance of monetary policy over the next two years than assumed in the December forecast. We now show the federal funds rate reaching 3 percent in the fourth quarter of this year and 3½ percent in the fourth quarter of 2006—in each case, 25 basis points higher than we previously assumed. Market participants have also marked up their expectations for tightening over our forecast period, but by slightly less than the staff. As a result, the gap between our assumed policy path and the market's has narrowed to less than ¼ percentage point, on average. Despite the upward revision to the market's expected policy path over the next several years, long-term interest rates have declined somewhat since we closed the December Greenbook. We have taken this decline on board and assume that long-term rates hold about steady at levels that are as much as 10 basis points lower than in the last forecast.

Broad equity market indexes have slipped about 1 percent below their levels at the time of the December Greenbook, and we have nudged down our starting level for stock prices by roughly this amount. We still assume that share prices will rise 6½ percent per year over the next two years, which would roughly maintain risk-adjusted parity with the yield on long-term bonds. For house prices, we continue to assume increases in the OFHEO repeat-transactions index of 5½ percent this year and 3½ percent in 2006 after an estimated rise of 11 percent in 2004.

We have revised down appreciably our estimates of the federal budget deficit for fiscal 2005 and fiscal 2006. On the receipts side, corporate tax payments in December were noticeably stronger than we had assumed, and we have boosted the level of future receipts. On the expenditure side, the monthly and daily Treasury estimates since the December Greenbook, have been showing that defense outlays have been running lower than we had written down. But at the same time, the forthcoming defense supplemental bill now appears likely to be larger than we had assumed. On balance, the news has delayed the timing of defense spending in our forecast and has only slightly reduced the level of outlays for fiscal 2005 as a whole. Working in the other direction, we raised our projection of mandatory spending in 2005 and 2006 to incorporate information gleaned from the recent CBO report. On net, our projection for the unified federal deficit in fiscal 2005 now stands at $365 billion, $31 billion below the level shown in the December Greenbook. The deficit is projected to narrow a bit further in fiscal 2006 to $358 billion. As was the case in our previous projection, we expect that the federal budget, after three years of substantial stimulus, will be a neutral influence on the change in real GDP in 2005 and that it will provide a small positive impetus in 2006.

Oil prices have been pushed higher in recent weeks by a combination of increased demand for heating fuels and a variety of supply disruptions. As a result, and in line with futures markets, we have raised our projected level for the price of West Texas intermediate (WTI) crude oil by $4.40 per barrel, to almost $48 per barrel in the first quarter, leaving it little changed from the level in the fourth quarter of last year. Futures markets continue to suggest that the price of crude oil will drift down over time, albeit on a more elevated path than in the December Greenbook. Our forecast of the price of WTI now stands at $46 per barrel at the end of this year and at $43 per barrel at the end of 2006. Compared with our previous forecast, this path averages about $4.60 per barrel higher this year and $3.60 per barrel higher in 2006.

As a result of movements in the foreign exchange value of the dollar since we closed the December Greenbook, its level at the start of the current forecast is 1¼ percent higher than we previously assumed. Over the forecast period, we again are projecting gradual depreciation at an annual rate of about 1¼ percent. We continue to expect that real economic activity abroad will expand 3¼ percent in both 2005 and 2006.

Recent Developments and the Near-Term Outlook

At the time of the December Greenbook, we expected real GDP to rise at an annual rate of 3¾ percent in both the third and fourth quarters. The information that has become available since then has altered the quarterly pattern and composition of the increases in real GDP over that period but, on balance, left our estimate of the level of output at year-end in line with our earlier forecast. Among the components of aggregate demand, consumer spending and outlays for residential construction turned out to have been stronger than we anticipated, and businesses appear to have accumulated non-auto inventories at a faster rate than we had expected. But offsetting those pluses were sharply weaker-than-anticipated real exports in the fourth quarter along with an unexpected dip in federal outlays for defense.[1]

Moving into the current quarter, a number of the most recent indicators, including the extent of the rebound in homebuilding and the apparent trajectory of real consumer spending at year-end, suggest slightly more near-term thrust to economic activity than we previously thought. In addition, motor vehicle manufacturers have upped their planned production this month, and production in other manufacturing industries strengthened noticeably at the end of last year. As a result, we have raised our projected increase in real GDP in the current quarter to an annual rate of 3¾ percent. Although the restraint associated with the temporary lull in equipment spending is no longer apparent in the top line, it is still operating beneath the surface. We have also marked up our projection for the increase in manufacturing industrial production 1¾ percentage points to an annual rate of 6 percent in the current quarter.

Consumer spending ended 2004 on a strong note, and we now estimate that real PCE rose at an annual rate of 4½ percent in the fourth quarter—1¼ percentage points faster than we projected in the December Greenbook. Consumers responded enthusiastically to the

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[1] The staff estimate of fourth-quarter real GDP includes forecasts of December data on inventory investment, exports and imports, and shipments of nondefense capital goods. When the BEA releases its advance estimate of real GDP on Friday, it will include new data on shipments (to be released on Thursday) and will make its own estimates of inventory investment, exports, and imports for December.

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

Measure	2004:Q4 Dec. GB	2004:Q4 Jan. GB	2005:Q1 Dec. GB	2005:Q1 Jan. GB
Real GDP	**3.7**	**3.5**	**3.4**	**3.8**
Private domestic final purchases	3.8	5.0	3.0	2.8
Personal consumption expenditures	3.3	4.6	3.7	3.7
Residential investment	1.0	3.9	2.6	3.1
Business fixed investment	9.1	8.3	-1.3	-3.2
Government outlays for consumption and investment	1.6	-.5	3.7	3.9
	Contribution to growth (percentage points)			
Inventory investment	.3	.8	.2	.3
Net exports	-.2	-1.5	-.0	.4

year-end push by motor vehicle manufacturers to boost sales of new vehicles, and retail sales of other goods were brisk. In addition, we assume that cold weather in December spurred a jump in the demand for energy services. The robust increase in spending in the fourth quarter left the personal saving rate—excluding the one-time Microsoft dividend—close to zero.[2]

We expect consumer spending to rise at a more moderate, but still solid, annual pace of 3¾ percent in the current quarter. Sales of light vehicles are likely to drop back a bit from the high fourth-quarter level—we have them receding to an annual rate of just under 17 million units, a pace in line with last year's average. But spending on other non-energy goods is projected to remain relatively strong, and households are anticipated to sharply boost their outlays for fuel oil and energy services.

The rebound in homebuilding in December put the average level of new single-family housing starts during the fourth quarter at an annual rate of 1.61 million units, which matched the robust pace that prevailed earlier in the year. The issuance of new permits and the backlog of unused permits at year-end suggest that, in the near term, single-

[2] We expect that the BEA will allocate three-fourths of the special Microsoft dividend payments to personal income, boosting the measured saving rate in 2004:Q4 by 1.1 percentage points; most of the remainder will be assigned to foreign shareholders.

family starts should remain near the fourth-quarter pace. In addition, in recent weeks, the rate on thirty-year fixed-rate mortgages has moved to the lower end of the range that has persisted since August, likely providing further support for a continued high level of housing activity early this year.

The available indicators suggest that business investment in equipment and software continued to increase at a solid pace during the fourth quarter; we estimate that real outlays were up at an annual rate of 11½ percent last quarter after a steeper rise of 17½ percent in the third quarter. The fourth quarter was marked by an acceleration in outlays for high-tech gear. But even spending for other types of equipment, which surged in the third quarter, rose at a respectable pace toward year-end. We have maintained our assumption that the expiration of the partial-expensing tax incentives on December 31 caused businesses to accelerate purchases of equipment in the second half of last year; as a result, we are projecting a temporary slump in purchases of both domestically produced and imported capital goods early this year. We now put the first-quarter decline at an annual rate of 5 percent—slightly steeper than we showed earlier because of a large projected drop-back in motor vehicle purchases following the year-end surge.
For nonresidential structures, the data available through November have yet to suggest an overall upturn in real spending. Only investment in drilling and mining showed consistent gains last year; the recovery in outlays on commercial structures that appeared to be under way during the spring and summer stalled in the fall; spending on manufacturing facilities remained depressed; and outlays for office buildings declined. Anecdotal reports suggest that conditions in the market for nonresidential structures have become less gloomy, and we think that spending will bottom out early this year.

Nonfarm businesses stepped up their accumulation of inventories in October and November. Leaving aside motor vehicles, higher rates of stockbuilding were widespread among manufacturers, wholesalers, and retailers as well as across stages of production. For these businesses, the aggregate inventory-sales ratio is likely to tick up in the fourth quarter but to a level that is still roughly consistent with its longer-run downtrend. Our flow-of-goods estimates and survey information from the purchasing managers' reports suggest that, in all but a few cases, businesses appear comfortable with the stockbuilding that has occurred.

Over the second half of last year, motor vehicle manufacturers chipped away at their high stock of unsold light vehicles by holding production relatively stable and working to maintain an elevated level of sales. Seemingly buoyed by the strength of sales at year-end, they have now boosted planned production for early this year, and we no longer expect a further reduction in dealer inventories this quarter. As a result of the higher level of assemblies that we are now projecting, we expect that, rather than having a neutral effect, gross motor vehicle output will provide a small plus for real GDP in the current quarter.

In the government sector, federal nondefense spending rose moderately in the fourth quarter, but defense spending was noticeably weaker than we had expected. As a result, we lowered our fourth-quarter estimate for real federal defense expenditures almost $10 billion (annual rate), leading to an estimated decline in total real federal expenditures on consumption and investment at an annual rate of 4 percent. We anticipate that defense spending will turn back up this quarter, and real federal expenditures on consumption and gross investment are projected to rise at an annual rate of 6½ percent. In the state and local sector, where fiscal conditions continue to improve, spending appears to be rising at a moderate pace. We are projecting increases in real expenditures at annual rates of 1½ percent in the fourth quarter and 2¼ percent in the current quarter.

The weakness in merchandise exports in October and November was quite surprising. Even assuming a sizable rebound in December, we are now estimating a small decline in real exports of goods and services in the fourth quarter, after three quarters in which real exports rose at an average annual rate of almost 7 percent. At the same time, imports increased rapidly, boosted by a surge in demand for imported oil. In our forecast, these data combine to arithmetically subtract 1½ percentage points from the change in real GDP in the fourth quarter. We are projecting that the demand for real exports will begin to get back on track with its longer-run fundamentals, rising at an annual rate of 7¾ percent in the current quarter. As a result of that improvement, along with an anticipated slowing of imports early this year, real net exports are projected to make a positive contribution of just under ½ percentage point to the change in real GDP this quarter.

In the labor market, monthly increases in private payroll jobs were uneven during the fourth quarter, but the average gain met our expectation of a firming in labor demand that we anticipate will extend into the current quarter. Monthly increases in private payroll employment, which had slowed to 93,000 in the third quarter of last year, averaged 181,000 during the fourth quarter, and we are projecting that net additions to private payrolls will average 200,000 per month this quarter. Private surveys of business hiring plans lend support to our view that job creation will continue to pick up. Nevertheless, the remaining slack in the labor market appears to be receding only gradually. The unemployment rate edged down another 0.1 percent, to 5.4 percent, in the fourth quarter, but new claims for unemployment insurance have averaged close to 340,000 per week since the spring. Businesses have reported only a modest uptick in the incidence of positions difficult to fill, and workers report that job openings are still relatively hard to find.

The CPI reports for November and December that we received after the last Greenbook both showed core consumer price inflation to have been very close to our expectations. As a result, core PCE prices appear to have risen at an annual rate of 1.4 percent in the fourth quarter of 2004, and we expect a similar increase in the first quarter of this year. At the same time, top-line PCE inflation continues to be buffeted by developments in energy prices. Another quarterly double-digit price increase for energy is expected to have boosted total PCE price inflation to an annual rate of 2¼ percent in the fourth quarter. In the current quarter, we continue to project a decline in energy prices, but the drop is expected to be less than we previously thought, putting overall PCE inflation at an annual rate of 1 percent—¼ percentage point above our previous forecast.

The Longer-Run Outlook for the Economy

The outlook for real activity over the longer term is roughly the same as that shown in the December Greenbook. This year, fiscal policy is expected to turn neutral, and monetary policy is assumed to be less accommodative. But the adverse effects of higher energy prices should wane, and household wealth should continue to rise. In addition, the drag from the external sector is projected to lessen noticeably as the demand for imports moderates and the demand for U.S. exports strengthens. As a result, we anticipate that real GDP will continue to increase at an annual rate of about 3¾ percent. By the second half of 2006, the ongoing withdrawal of monetary policy accommodation, a lack of further stimulus from household wealth, and a pickup in import demand are expected to have gradually slowed the rise in real GDP to closer to 3½ percent.

Household spending. Real PCE is projected to rise at an annual rate of about 3¾ percent over the forecast period, a shade below the pace during the past two years. Gains in real disposable personal income this year and next are anticipated to receive a boost from the projected decline in energy prices and from the strengthening in employment even as the stimulus from the earlier tax cuts disappears. In addition, although short-term interest rates are expected to rise further, the average interest rate on outstanding household debt is expected to remain low, and households should face no serious problems in managing

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

Measure	2004: H2	2005: H1	2005	2006
Real GDP	**3.7**	**3.9**	**3.9**	**3.6**
Previous	3.7	3.7	3.9	3.7
Final sales	3.9	4.3	4.1	3.6
Previous	4.1	4.0	4.0	3.7
PCE	4.9	3.8	3.8	3.7
Previous	4.2	3.9	4.0	3.9
Residential investment	2.7	3.7	2.7	1.0
Previous	1.2	2.6	2.5	1.4
BFI	10.6	3.2	5.9	8.3
Previous	10.9	3.6	6.4	8.3
Government purchases	.1	3.4	3.0	2.5
Previous	1.2	2.9	2.6	2.5
Exports	2.5	8.3	8.7	7.2
Previous	8.2	7.5	8.3	7.6
Imports	7.0	2.6	5.2	7.6
Previous	6.8	3.8	5.9	8.1
	Contribution to growth (percentage points)			
Inventory change	-.1	-.4	-.2	.1
Previous	-.4	-.3	-.1	.0
Net exports	-.8	.4	.0	-.4
Previous	-.2	.2	-.1	-.5

the debt that we are projecting. That said, the strength in consumer spending in late 2004 appears to have further depressed the already low personal saving rate. As a consequence, in addition to the slight drag on spending from household wealth in 2006, consumer spending should tend to be restrained by the need of households to rebuild savings.

Demand for housing over the next two years is expected to receive ongoing support from the availability of mortgages at interest rates as favorable as those that prevailed during

2003 and 2004. We are projecting that starts of new single-family homes will remain just above 1.6 million units per year in the first half of 2005 and then will gradually drift below that mark in 2006. At the same time, we expect multifamily starts to be fairly stable at 350,000 units per year. Accordingly, the contribution of outlays for residential investment to real GDP is projected to diminish over the forecast period.

Business investment. Our projection for real investment in equipment and software continues to show increases of 6½ percent in 2005 and 9¾ percent in 2006; after the temporary pause in spending that we expect to see in the current quarter, the rise in outlays is fairly steady. The pace of business spending on high-tech equipment is anticipated to move up closer to its longer-run average, rising at an annual rate of about 17 percent from the second quarter through the end of 2006. Outlays for other types of equipment are projected to remain on a solid uptrend. Overall, the economic environment that we are forecasting is conducive to investment: Businesses should see their sales rise steadily, they should be responding to an ongoing need to replace and upgrade equipment and software, and they should have ample cash and face favorable financing conditions.

After having rebuilt inventories during 2004, we expect that nonfarm businesses will slow their rates of inventory accumulation. As a result, nonfarm inventory investment, after having contributed roughly ½ percentage point to the change in real GDP during 2004, is projected to subtract ¼ percentage point in 2005 and to be a neutral influence in 2006. Last year's rise in the nonfarm inventory-sales ratio appears to have retraced only part of its steep decline in 2003, and, as businesses continue to make ongoing improvements in their ability to manage their stocks, we are projecting that the ratio of stocks to sales will drift lower over the forecast period.

Government spending. Starting from the weaker level now estimated for the fourth quarter of 2004, total real federal expenditures for consumption and investment are projected to increase 4 percent in 2005 and then to rise a little less than 2 percent in 2006. At the state and local level, the ongoing improvement in the economy that we are forecasting should engender a moderate pickup in spending over the next two years. We are projecting that, after having risen just ½ percent in 2003 and 2004, real state and local purchases will be up 2½ percent during 2005 and 2¾ percent during 2006.

Net exports. With the dollar assumed to depreciate gradually and with economic activity abroad expected to be expanding at a moderate pace, real exports of goods and services

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

Measure	1974-95	1996-2001	2002	2003	2004	2005	2006
Structural labor productivity	**1.5**	**2.7**	**3.2**	**3.7**	**3.0**	**2.7**	**2.7**
Previous	1.5	2.7	3.2	3.7	3.0	2.7	2.7
Contributions[1]							
Capital deepening	.7	1.3	.6	.6	.8	.9	.9
Previous	.7	1.3	.6	.6	.8	.8	.9
Multifactor productivity	.5	1.1	2.4	2.8	2.0	1.6	1.5
Previous	.5	1.1	2.4	2.8	2.0	1.6	1.5
Labor composition	.3	.3	.3	.3	.3	.3	.3
MEMO							
Potential GDP	3.0	3.4	3.4	3.8	3.4	3.2	3.2
Previous	3.0	3.4	3.4	3.8	3.4	3.1	3.2

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

1. Percentage points.

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

Measure	2003	2004	2005	2006
Output per hour, nonfarm business	5.6	2.8	1.7	2.2
Previous	5.6	2.8	1.7	2.2
Nonfarm private payroll employment	-.2	1.8	2.2	1.9
Previous	-.2	1.8	2.2	2.0
Household survey employment	1.2	1.3	1.8	1.5
Previous	1.2	1.3	1.7	1.5
Labor force participation rate[1]	66.1	66.0	66.3	66.4
Previous	66.1	66.0	66.3	66.4
Civilian unemployment rate[1]	5.9	5.4	5.3	5.1
Previous	5.9	5.4	5.3	5.1
MEMO				
GDP gap[2]	1.7	1.3	.6	.2
Previous	1.7	1.3	.6	.1

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

are projected to increase 8¾ percent during 2005 and 7¼ percent during 2006. Underlying that projection is our assumption that some weakness in exports at the end of 2004 will be made up during subsequent quarters while, toward the end of the forecast period, the lagged effects of the earlier rapid decline in the dollar fade. The increase in real imports of goods and services is expected to moderate to 5¼ percent this year as oil imports drop back from their fourth-quarter surge and purchases of capital goods are held down by the end of partial-expensing tax incentives. Real imports are then projected to rise 7½ percent in 2006. As a result, real net exports of goods and services have little influence on the change in real GDP this year but subtract close to ½ percentage point in 2006. *(The International Developments section provides more detail on the outlook for the external sector.)*

Aggregate Supply, the Labor Market, and Inflation

We estimate that potential output will increase 3¼ percent per year over the forecast period and that the rate of increase in real GDP that we are forecasting will close nearly all the existing output gap by the end of 2006. Likewise, the unemployment rate is projected to fall gradually, ending the forecast period just slightly above our estimate of the natural rate. Core inflation is projected to remain subdued while headline price inflation is pulled lower by declining energy prices.

Productivity and the labor market. We expect that, over the next several months, the pace of hiring will strengthen as businesses gain more confidence in the economic outlook. Thus, we are projecting net additions to private nonfarm payrolls of 210,000 per month this year. Job creation is then assumed to taper off a bit in 2006 as increases in production and sales moderate. The labor market is expected to be sufficiently strong this year and next to induce both a noticeable rise in labor force participation and a further downtrend in the unemployment rate.

We now estimate that nonfarm labor productivity decelerated to an annual rate of about 2 percent in the second half of 2004; this development accords with our assumption that, after an extended period in which rapid gains lifted the level of output per hour well above its structural trend, that gap would begin to close as labor demand picked up. Under our assumption of solid increases in hours worked over the next two years, the gap between the levels of actual and structural productivity, which we estimate to have been almost 1¾ percent at the end of 2004, is largely eliminated. Specifically, projected increases in actual productivity of 1¾ percent in 2005 and 2¼ percent in 2006 fall short of the structural rate of 2¾ percent that we assume will prevail over that time frame.

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

Measure	2003	2004	2005	2006
PCE chain-weighted price index	1.7	2.5	1.3	1.3
Previous	1.7	2.5	1.2	1.3
Food and beverages	2.7	2.9	2.0	1.8
Previous	2.7	3.0	2.0	1.8
Energy	7.2	17.8	-3.4	-1.2
Previous	7.2	17.8	-6.4	-0.3
Excluding food and energy	1.2	1.5	1.6	1.4
Previous	1.2	1.5	1.6	1.4
Consumer price index	1.9	3.4	1.5	1.6
Previous	1.9	3.4	1.4	1.7
Excluding food and energy	1.2	2.1	2.0	1.8
Previous	1.2	2.2	2.0	1.8
GDP chain-weighted price index	1.7	2.3	1.5	1.6
Previous	1.7	2.3	1.5	1.6
ECI for compensation of private industry workers[1]	4.0	4.0	4.3	4.2
Previous	4.0	4.0	4.2	4.1
NFB compensation per hour	5.4	4.0	4.2	4.2
Previous	5.4	3.8	4.2	4.2
Prices of core nonfuel imports	1.6	3.8	1.2	.2
Previous	1.6	3.7	1.0	.1

1. December to December.

Prices and labor costs. Our forecasts for total PCE price inflation are 1.3 percent in both 2005 and 2006—down sharply from the increase of 2½ percent during 2004. The revisions to our projections of energy prices in this forecast are relatively small: They add roughly 0.1 percentage point to overall consumer price inflation this year and subtract a similar amount in 2006. We continue to project that core PCE price inflation will average 1½ percent per year over the next two years—the same as during 2004. As has been the case for some time, the fundamental factors underlying this stability in our inflation forecast are little changed: Over the forecast period, the upward pressures on inflation from diminishing economic slack and from a slightly slower rise in structural productivity are offset by a waning of the influence of higher prices for energy and imports on core inflation. Inflation expectations are anticipated to be stable. At the same time, we expect that the ongoing improvement in labor markets will result in some pickup in wage increases. We are projecting that the ECI for compensation of private-industry workers, which is estimated to have risen 4 percent in 2004, will increase about 4¼ percent in 2005 and 2006.

Financial Flows and Conditions

Domestic nonfinancial debt is estimated to have increased 7¾ percent last year. We expect that debt will rise more slowly over the forecast period—7¼ percent this year and 6½ percent in 2006—essentially the same path as in the December Greenbook. A slowdown in household and government borrowing is anticipated to more than offset a modest pickup in business borrowing.

Household debt, which rose at a robust pace of 9¾ percent last year, is expected to increase 8 percent this year and 7 percent in 2006. The deceleration reflects our expectation that more-moderate house price appreciation will temper the rise in mortgage debt relative to its rapid pace of the past couple of years. In contrast, after having been sluggish of late, the expansion of consumer credit is expected to pick up a bit over the forecast period, in part because we assume that households will rely less on home equity extraction to finance spending.

Supported by an upturn in short-term debt outstanding after three years of runoffs, nonfinancial business debt increased 5 percent during 2004. We anticipate that nonfinancial business debt will increase modestly faster this year and next—about 6¼ percent per year—consistent with our projection for an ongoing rise in business fixed investment.

Corporate tax receipts at the end of last year were stronger than expected. We now estimate that federal debt increased about 9 percent last year—¾ percentage point less than expected in the December Greenbook. Looking ahead, we anticipate that the deficit will narrow and that the increases in federal debt will move down to about 8¼ percent this year and next.

State and local government debt expanded an estimated 7¼ percent last year, but it is expected to decelerate to 4 percent this year and 3 percent in 2006, reflecting a drop in advance refundings even as financing for new capital expenditures is anticipated to remain strong.

After having increased 5¼ percent in 2004, M2 is projected to rise 4 percent this year and 4½ percent during 2006. Money demand is anticipated to expand somewhat less than nominal income over the forecast period mainly because of the rising opportunity costs associated with monetary policy tightening.

Alternative Simulations

In this section we evaluate several risks to the forecast using simulations of the FRB/US model. We begin with the inflation outlook and the chance that both the ability of firms to pass through costs and the magnitude of those costs will be greater than we expect. We then consider a more benign inflation scenario in which structural productivity expands more rapidly than in the baseline. The next set of simulations involves alternative assumptions about three key elements in the outlook for real GDP—the effects of partial expensing on business investment, the trajectory of the personal saving rate, and the trend in house prices. We conclude with two alternative financial scenarios: first, an appreciable rise in bond yields and, second, a path for the federal funds rate consistent with current readings from the futures market. In all but the last simulation, the federal funds rate is held at its baseline path.

Flat markup. In the baseline, because competitive pressures prevent firms from fully passing on projected cost increases, the markup of nonfarm business prices over structural unit labor costs falls an appreciable amount. However, pricing power has reportedly increased for at least some firms, and one risk is that businesses may prove more successful than we anticipate in maintaining profit margins. This scenario assumes nonfarm businesses are able to maintain their price markup at its current level through 2006. As a result, core PCE price inflation rises to 1¾ percent this year and next. Real GDP and the unemployment rate differ little from the baseline; although faster inflation provides more stimulus to real activity through a lower level of real interest rates, that stimulus is offset by weaker gains in real labor income.

Flat markup and higher compensation inflation. In addition to the possibility that firms may have a greater ability to pass on costs, they may face a more rapid rise in their costs than we project. In particular, the baseline assumes that employer costs for health insurance will continue to rise at last year's more moderate rate of 7 percent; in light of persistent concerns about health-care costs, that assumption may be too optimistic. Also, given recent anecdotes of shortages for certain skilled workers and the observation that an unusually high percentage of layoffs over the past few years may have been permanent, we may have overestimated the amount of slack in labor markets. This scenario maintains the assumption of an unchanged markup and further assumes that the NAIRU has been 5½ percent for some time—½ percentage point higher than the staff estimate. It also assumes that employer health-care costs rise 10 percent in both 2005 and 2006—about the same as the average rate of increase seen during the period from 2001 to 2003. Under these conditions, core PCE inflation jumps to 2½ percent in 2006. Even though the higher rate of inflation reduces real interest rates, real GDP is affected only a little because of the offsetting influence of the higher NAIRU on permanent income and profits. As a result, the output gap closes by early 2006, and the economy operates above potential thereafter. Likewise, the unemployment rate lies a little below the NAIRU by late next year.

Faster productivity growth. The baseline forecast incorporates a slowing in the rate of increase of multifactor productivity, from our estimated average of almost 2½ percent per year from 2001 to 2003 to 2 percent in 2004 and then to 1½ percent per year in 2005 and 2006—a rate in line with its historical average. However, we may be underestimating the ongoing pace of technological innovation and its contribution to both recent and future gains in output per hour. This scenario assumes that multifactor productivity increased 2¼ percent in 2004 and will continue to do so through 2006. This adjustment implies a brighter outlook for household income and corporate profits and thus stronger gains in consumer spending and business investment. However, assuming that financial market participants already share this view of the economy's growth potential, the change does not imply any major revision to asset prices. Under these conditions, real GDP increases 4½ percent in 2005 and 2006, and the unemployment rate falls to 4¾ percent by late next year. Because wages respond sluggishly to higher levels of trend labor productivity and the tighter labor market, trend unit labor costs decline relative to the baseline. As a result, core PCE inflation moves down to 1 percent in 2006.

No investment pothole. We expect that expenditures on equipment and software will decelerate sharply this quarter, largely as a result of the expiration of the partial-expensing provision. Nonetheless, we recognize the considerable uncertainty that surrounds estimates of both the past and future spending effects of the tax incentive. This scenario assumes that partial expensing has in fact had no stimulative effect on equipment outlays over the past three years. Thus, we face no E&S pothole and no accompanying swings in inventories and imports. Rather, the observed pace of business investment has represented greater underlying strength, not temporary stimulus. All told,

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

Measure and scenario	2004 Q4	2005 H1	2005 H2	2006
Real GDP				
Baseline	**3.5**	**3.9**	**3.8**	**3.6**
Flat markup	3.5	3.9	3.8	3.7
And higher compensation inflation	3.5	3.8	3.6	3.6
Faster productivity growth	3.5	4.4	4.7	4.6
No investment pothole	3.5	4.7	4.3	4.3
Stronger consumption	3.5	4.1	4.2	4.0
Real estate slump	3.5	3.9	3.6	3.2
With a loss of consumer confidence	3.5	3.8	3.4	2.9
Higher long-term interest rates	3.5	3.8	3.0	2.6
Market-based funds rate	3.5	3.9	3.7	3.4
Civilian unemployment rate[1]				
Baseline	**5.4**	**5.3**	**5.3**	**5.1**
Flat markup	5.4	5.3	5.3	5.1
And higher compensation inflation	5.4	5.4	5.5	5.4
Faster productivity growth	5.4	5.2	5.1	4.8
No investment pothole	5.4	5.2	5.1	4.6
Stronger consumption	5.4	5.3	5.2	4.7
Real estate slump	5.4	5.3	5.3	5.3
With a loss of consumer confidence	5.4	5.3	5.4	5.5
Higher long-term interest rates	5.4	5.3	5.5	5.8
Market-based funds rate	5.4	5.3	5.3	5.2
PCE prices excluding food and energy				
Baseline	**1.4**	**1.5**	**1.6**	**1.4**
Flat markup	1.4	1.7	1.8	1.8
And higher compensation inflation	1.4	2.0	2.3	2.4
Faster productivity growth	1.4	1.3	1.3	1.0
No investment pothole	1.4	1.5	1.6	1.4
Stronger consumption	1.4	1.5	1.6	1.5
Real estate slump	1.4	1.5	1.6	1.4
With a loss of consumer confidence	1.4	1.5	1.6	1.3
Higher long-term interest rates	1.4	1.4	1.5	1.2
Market-based funds rate	1.4	1.5	1.6	1.4

1. Average for the final quarter of the period.

real E&S outlays rise almost 13 percent in both 2005 and 2006, compared with 8¼ percent on average in the baseline. Real GDP increases 4½ percent this year and 4¼ percent in 2006, and the unemployment rate moves down to 4½ percent by late 2006. Inflation is little changed because the pressure from stronger demand is offset by increased capital deepening and thus a faster rise in structural productivity.

Stronger consumption. We view the recent level of the personal saving rate as unsustainably low and project it to rise gradually over time. However, as yet, the recent data offer no clear sign that this adjustment has begun; indeed, consumer spending at year-end was noticeably stronger than we had expected. In this scenario, households do not appreciably increase their saving in response to a falling wealth-to-income ratio and rising interest rates. As a result, the saving rate is only 0.9 percent in 2006—a full percentage point below baseline. Stronger consumption boosts the increase in real GDP to about 4 percent in both 2005 and 2006, and the unemployment rate moves down to 4¾ percent by late next year. Inflation is a touch higher than in the baseline as a result.

Real estate slump. The multiyear surge in residential real estate values continued into the third quarter of 2004, and houses are expected to appreciate through next year, albeit at a more moderate pace. Despite the moderation, the tension between market values and apparent fundamentals persists over the forecast period, raising the possibility of a substantial correction at some point. In this scenario (which repeats an exercise that we included in the December Greenbook), house prices decline roughly 10 percent by the end of 2006 from their current level, leaving them 20 percent below the baseline forecast. The consequent loss in wealth restrains household spending and raises the personal saving rate about ¾ percentage point above baseline by the end of 2006. As a result, real GDP rises more slowly, only 3¼ percent in 2006, and the unemployment rate stays close to 5¼ percent through the end of next year. Inflation is little affected but would be poised to move down in 2007 in the absence of a monetary response.

Real estate slump with a loss of consumer confidence. The measured response of household spending to the decline in real estate values portrayed in the previous scenario is itself subject to many risks. One is that such a dramatic change in real estate markets would come as a considerable surprise to households, thereby causing consumer confidence to drop significantly. In this scenario, we assume that such a decline in sentiment further boosts the personal saving rate so that it exceeds 3 percent by the end of

2006. The effects on real GDP and the unemployment rate are twice as large as in the preceding scenario, while inflation is a touch lower in 2006.

Higher long-term interest rates. We expect bond yields to remain at their current low levels, but we recognize several upside risks. First, our assumption that investors will come to share our more optimistic outlook for long-run inflation may not be realized as early as 2006. Second, the current low level of term premiums on Treasury securities—perhaps stemming from strong demand for longer-term Treasuries by Asian central banks or from a perceived reduction in interest rate risk as reflected in low levels of implied volatility—may not continue as expected. Finally, if long-term rates were to rise and weaken real economic activity, risk spreads on private securities over Treasuries might increase in response. All three possibilities occur in this scenario, causing the yield on ten-year Treasuries to be, on average, 60 basis points higher than the baseline in 2006; yields on BAA corporate bonds increase more than 80 basis points by late next year. The higher interest rates restrain consumption and investment, and real GDP increases only 3½ percent in 2005 and 2½ percent in 2006. Weaker real activity causes the unemployment rate to rise to 5¾ percent by late next year and inflation to slow to 1¼ percent.

Market-based funds rate. Quotes from futures markets imply a path for the federal funds rate that is about 20 basis points higher, on average, than the baseline path through 2006. Taking on board the market's path for the funds rate slows the rise in real GDP modestly later this year and in 2006; as a result, the unemployment rate is a little higher, and inflation is unchanged.

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

Measure	2004	2005	2006
Real GDP			
(percent change, Q4 to Q4)			
Projection	3.8	3.9	3.6
Confidence interval			
Greenbook forecast errors[1]	3.6–4.0	2.2–5.5	1.9–5.3
FRB/US stochastic simulations	3.6–3.9	2.5–5.4	1.9–5.4
Civilian unemployment rate			
(percent, Q4)			
Projection	5.4	5.3	5.1
Confidence interval			
Greenbook forecast errors[1]	5.4–5.4	4.7–5.8	4.1–6.1
FRB/US stochastic simulations	5.4–5.5	4.6–5.9	4.0–6.0
PCE prices			
excluding food and energy			
(percent change, Q4 to Q4)			
Projection	1.5	1.6	1.4
Confidence interval			
Greenbook forecast errors[2]	1.4–1.6	1.0–2.1	.4–2.3
FRB/US stochastic simulations	1.5–1.6	1.0–2.2	.6–2.3

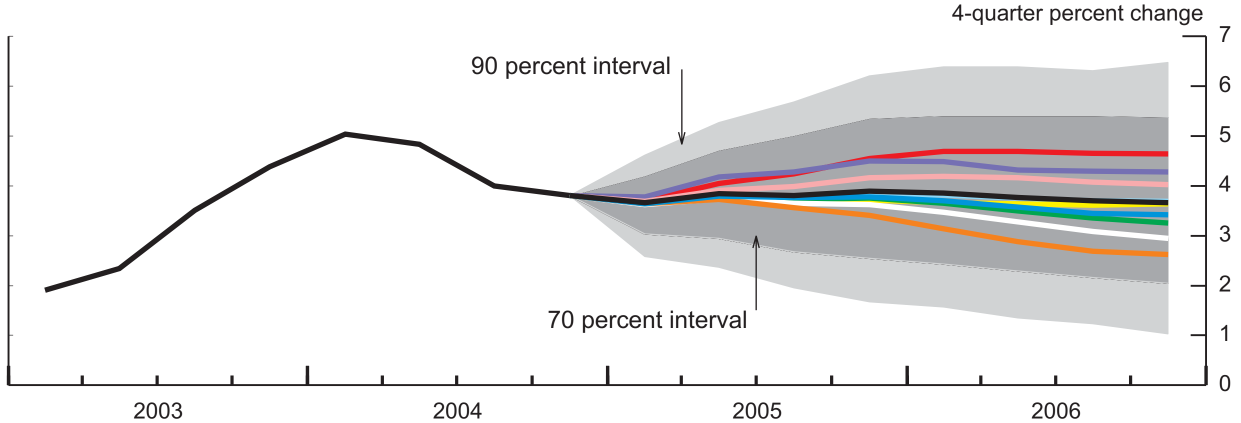
NOTE. Shocks underlying stochastic simulations are randomly drawn from the 1978–2003 set of model equation residuals.

1. 1978–2003.
2. 1981–2003.

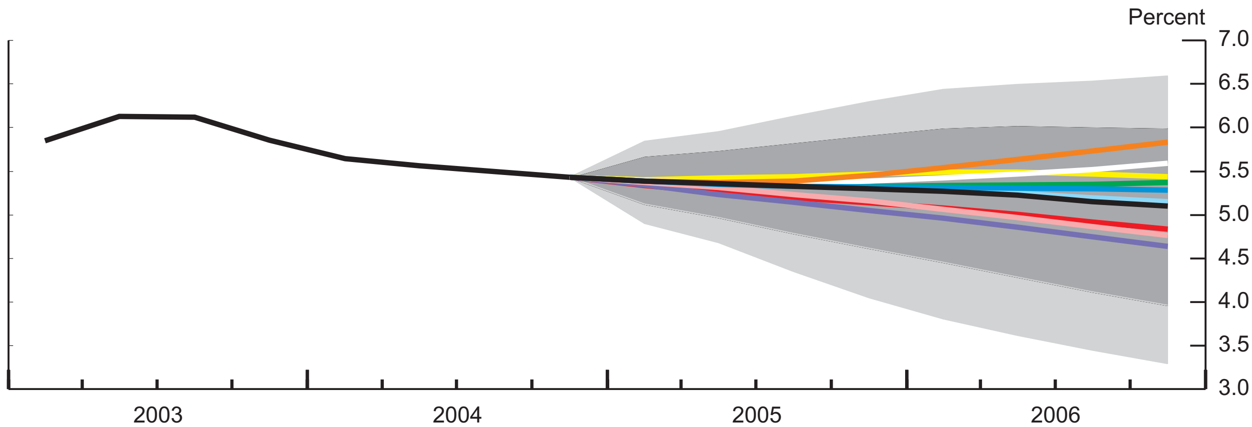
Forecast Confidence Intervals and Alternative Scenarios

Confidence Intervals Based on FRB/US Stochastic Simulations

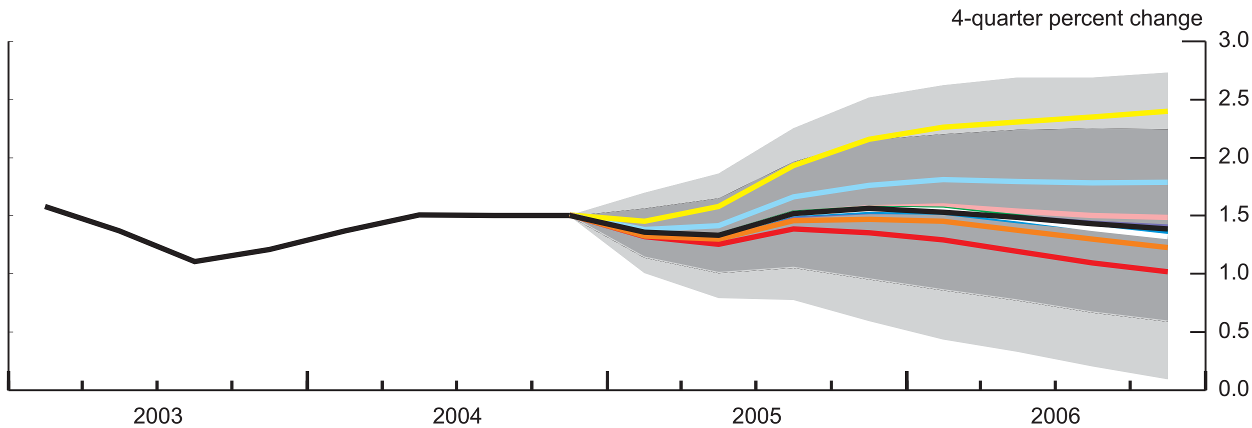
Real GDP



Unemployment Rate



PCE Prices excluding Food and Energy



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

Interval		Nominal GDP		Real GDP		GDP chain-weighted price index		Consumer price index[1]		Unemployment rate[2]	
		12/08/04	1/26/05	12/08/04	1/26/05	12/08/04	1/26/05	12/08/04	1/26/05	12/08/04	1/26/05
ANNUAL											
2002		3.5	3.5	1.9	1.9	1.7	1.7	1.6	1.6	5.8	5.8
2003		4.9	4.9	3.0	3.0	1.8	1.8	2.3	2.3	6.0	6.0
2004		6.6	6.6	4.4	4.4	2.1	2.1	2.7	2.7	5.5	5.5
2005		5.5	5.5	3.8	3.8	1.6	1.6	1.9	2.1	5.3	5.3
2006		5.5	5.4	3.9	3.7	1.6	1.6	1.7	1.6	5.2	5.2
QUARTERLY											
2003	Q1	4.9	4.9	1.9	1.9	2.7	2.7	3.8	3.8	5.8	5.8
	Q2	5.3	5.3	4.1	4.1	1.1	1.1	0.7	0.7	6.1	6.1
	Q3	8.8	8.8	7.4	7.4	1.4	1.4	2.4	2.4	6.1	6.1
	Q4	5.7	5.7	4.2	4.2	1.6	1.6	0.7	0.7	5.9	5.9
2004	Q1	7.4	7.4	4.5	4.5	2.8	2.8	3.5	3.5	5.6	5.6
	Q2	6.6	6.6	3.3	3.3	3.2	3.2	4.8	4.8	5.6	5.6
	Q3	5.1	5.5	3.7	4.0	1.3	1.4	1.9	1.9	5.5	5.5
	Q4	5.6	5.4	3.7	3.5	1.9	1.9	3.6	3.4	5.4	5.4
2005	Q1	5.1	5.1	3.4	3.8	1.6	1.3	0.6	1.0	5.4	5.4
	Q2	5.4	5.6	4.0	4.0	1.3	1.6	1.4	1.8	5.3	5.3
	Q3	5.7	5.6	4.1	3.9	1.5	1.6	1.7	1.7	5.3	5.3
	Q4	5.7	5.4	4.0	3.8	1.6	1.5	1.7	1.6	5.3	5.3
2006	Q1	5.8	5.7	3.8	3.7	1.9	1.9	1.7	1.6	5.2	5.3
	Q2	5.3	5.2	3.7	3.6	1.5	1.6	1.6	1.6	5.2	5.2
	Q3	5.2	5.1	3.7	3.6	1.5	1.5	1.7	1.6	5.1	5.2
	Q4	5.2	5.1	3.7	3.6	1.5	1.4	1.7	1.6	5.1	5.1
TWO-QUARTER[3]											
2003	Q2	5.1	5.1	3.0	3.0	1.9	1.9	2.2	2.2	0.2	0.2
	Q4	7.2	7.2	5.8	5.8	1.5	1.5	1.5	1.5	-0.2	-0.2
2004	Q2	7.0	7.0	3.9	3.9	3.0	3.0	4.2	4.2	-0.3	-0.3
	Q4	5.4	5.4	3.7	3.7	1.6	1.6	2.7	2.6	-0.2	-0.2
2005	Q2	5.3	5.3	3.7	3.9	1.5	1.4	1.0	1.4	-0.1	-0.1
	Q4	5.7	5.5	4.1	3.8	1.6	1.6	1.7	1.6	0.0	0.0
2006	Q2	5.5	5.4	3.7	3.6	1.7	1.7	1.7	1.6	-0.1	-0.1
	Q4	5.2	5.1	3.7	3.6	1.5	1.5	1.7	1.6	-0.1	-0.1
FOUR-QUARTER[4]											
2002	Q4	3.8	3.8	2.3	2.3	1.6	1.6	2.2	2.2	0.3	0.4
2003	Q4	6.2	6.2	4.4	4.4	1.7	1.7	1.9	1.9	0.0	0.0
2004	Q4	6.2	6.2	3.8	3.8	2.3	2.3	3.4	3.4	-0.5	-0.5
2005	Q4	5.5	5.4	3.9	3.9	1.5	1.5	1.4	1.5	-0.1	-0.1
2006	Q4	5.4	5.3	3.7	3.6	1.6	1.6	1.7	1.6	-0.2	-0.1

1. For all urban consumers.
2. Level, except as noted.
3. Percent change from two quarters earlier; for unemployment rate, change in percentage points.
4. Percent change from four quarters earlier; for unemployment rate, change in percentage points.

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REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS, ANNUAL VALUES
(Seasonally adjusted annual rate)

								- - - - -	Projected	- - - - -
Item	Units[1]	1998	1999	2000	2001	2002	2003	2004	2005	2006
Expenditures										
Nominal GDP	Bill. $	8747.0	9268.4	9817.0	10128.0	10487.0	11004.0	11728.9	12369.8	13038.8
Real GDP	Bill. Ch. $	9066.9	9470.3	9817.0	9890.7	10074.8	10381.3	10839.3	11248.0	11665.0
Real GDP	% change	4.5	4.7	2.2	0.2	2.3	4.4	3.8	3.9	3.6
Gross domestic purchases		5.5	5.5	3.0	0.4	3.1	4.3	4.5	3.6	3.8
Final sales		4.8	4.2	2.9	1.5	1.2	4.5	3.4	4.1	3.6
Priv. dom. final purchases		6.4	5.3	4.3	1.0	1.7	4.9	4.7	4.0	4.1
Personal cons. expenditures		5.4	4.9	4.1	2.8	2.5	3.8	3.9	3.8	3.7
Durables		14.4	7.3	4.7	10.8	1.5	9.9	5.6	6.0	6.3
Nondurables		4.7	4.9	3.0	1.9	2.3	4.6	4.4	4.5	4.4
Services		3.8	4.4	4.5	1.6	2.9	2.2	3.3	3.0	2.9
Business fixed investment		10.9	7.7	7.8	-9.6	-6.0	9.4	9.4	5.9	8.3
Equipment & Software		13.5	10.8	7.5	-9.0	-2.2	12.1	12.8	6.6	9.8
Nonres. structures		4.0	-0.9	8.8	-11.1	-16.1	1.5	-1.2	3.6	3.4
Residential structures		10.3	3.6	-1.9	1.4	6.9	12.0	6.6	2.7	1.0
Exports		2.6	5.6	6.5	-11.9	3.5	6.1	4.9	8.7	7.2
Imports		11.0	12.1	11.2	-7.6	9.7	4.9	9.3	5.2	7.6
Gov't. cons. & investment		3.3	4.2	0.4	5.0	3.8	2.2	1.2	3.0	2.5
Federal		0.1	4.2	-2.2	6.4	8.2	5.5	2.6	4.0	1.9
Defense		-1.2	4.3	-3.5	6.5	8.5	8.5	3.6	5.4	2.3
State & local		5.1	4.2	1.7	4.2	1.6	0.4	0.4	2.5	2.8
Change in bus. inventories	Bill. Ch. $	72.6	68.9	56.5	-31.7	11.7	-0.7	47.6	39.2	37.5
Nonfarm		71.2	71.5	57.8	-31.8	13.5	-1.1	43.9	36.7	35.3
Net exports		-203.8	-296.2	-379.5	-399.1	-472.1	-518.5	-584.5	-609.5	-648.4
Nominal GDP	% change	5.7	6.3	4.6	2.7	3.8	6.2	6.2	5.4	5.3
GDP Gap[2]	%	-1.6	-2.4	-2.5	0.1	1.6	2.2	1.4	0.9	0.4
Employment and Production										
Nonfarm payroll employment	Millions	125.9	129.0	131.8	131.8	130.3	129.9	131.3	133.8	136.4
Unemployment rate	%	4.5	4.2	4.0	4.7	5.8	6.0	5.5	5.3	5.2
Industrial prod. index	% change	4.2	5.2	1.9	-5.1	1.5	1.2	4.2	5.3	4.4
Capacity util. rate - mfg.	%	81.8	81.1	80.6	74.5	73.5	73.7	76.7	79.2	81.3
Housing starts	Millions	1.62	1.64	1.57	1.60	1.70	1.85	1.95	1.96	1.94
Light motor vehicle sales		15.52	16.90	17.35	17.12	16.79	16.62	16.83	17.31	17.86
North Amer. produced		13.48	14.41	14.48	14.04	13.49	13.32	13.44	13.83	14.28
Other		2.03	2.49	2.87	3.08	3.30	3.31	3.39	3.48	3.58
Income and Saving										
Nominal GNP	Bill. $	8768.3	9302.2	9855.9	10171.6	10514.1	11059.2	11768.0	12367.0	12992.0
Nominal GNP	% change	5.5	6.5	4.7	2.9	3.5	6.5	5.5	5.2	4.9
Nominal personal income		7.0	5.5	7.1	2.2	1.9	4.6	6.1	5.4	6.3
Real disposable income		5.6	2.8	4.4	1.2	2.9	3.9	3.7	3.4	4.7
Personal saving rate	%	4.3	2.4	2.3	1.8	2.0	1.4	1.0	0.6	1.7
Corp. profits, IVA & CCAdj.	% change	-10.0	9.6	-8.6	-0.2	15.4	23.3	7.3	1.2	-1.4
Profit share of GNP	%	9.1	9.2	8.3	7.5	8.3	9.2	9.9	9.9	9.4
Excluding FR Banks		8.9	8.9	8.0	7.3	8.1	9.1	9.8	9.8	9.2
Federal surpl./deficit	Bill. $	38.8	103.6	189.5	46.7	-254.5	-364.5	-376.5	-269.3	-319.2
State & local surpl./def.		52.0	50.4	50.0	4.8	-25.0	-3.2	10.7	7.7	9.2
Ex. social ins. funds		50.3	48.7	47.9	2.2	-26.6	-4.3	9.3	6.1	7.6
Gross natl. saving rate	%	18.2	18.0	18.0	16.3	14.1	13.5	13.5	13.3	13.5
Net natl. saving rate		7.4	6.9	6.7	4.2	2.0	1.4	1.7	1.8	2.0
Prices and Costs										
GDP chn.-wt. price index	% change	1.1	1.6	2.2	2.4	1.6	1.7	2.3	1.5	1.6
Gross Domestic Purchases chn.-wt. price index		0.7	2.0	2.4	1.6	1.8	1.8	2.8	1.5	1.4
PCE chn.-wt. price index		0.9	2.1	2.3	1.7	1.8	1.7	2.5	1.3	1.3
Ex. food and energy		1.4	1.6	1.5	2.2	1.5	1.2	1.5	1.6	1.4
CPI		1.5	2.6	3.4	1.8	2.2	1.9	3.4	1.5	1.6
Ex. food and energy		2.3	2.0	2.6	2.7	2.0	1.2	2.1	2.0	1.8
ECI, hourly compensation[3]		3.5	3.4	4.4	4.2	3.2	4.0	4.0	4.3	4.2
Nonfarm business sector										
Output per hour		2.7	3.4	2.1	3.3	3.5	5.6	2.8	1.7	2.2
Compensation per Hour		5.5	5.2	6.4	3.5	2.9	5.4	4.0	4.2	4.2
Unit labor cost		2.7	1.7	4.3	0.3	-0.6	-0.2	1.1	2.4	2.0

1. Changes are from fourth quarter to fourth quarter.
2. Percent difference between potential and actual. A positive number indicates that the economy is operating below potential.
3. Private-industry workers.

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

Item	Units	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2
Expenditures											
Nominal GDP	Bill. $	10338.2	10445.7	10546.5	10617.5	10744.6	10884.0	11116.7	11270.9	11472.6	11657.5
Real GDP	Bill. Ch. $	9993.5	10052.6	10117.3	10135.9	10184.4	10287.4	10472.8	10580.7	10697.5	10784.7
Real GDP	% change	3.4	2.4	2.6	0.7	1.9	4.1	7.4	4.2	4.5	3.3
Gross domestic purchases		4.4	2.8	2.9	2.4	1.7	4.4	6.4	4.7	5.0	4.2
Final sales		0.3	1.8	2.0	0.7	2.4	5.2	6.8	3.7	3.3	2.5
Priv. dom. final purchases		0.7	1.7	2.4	1.9	2.6	5.1	7.2	4.8	4.2	3.7
Personal cons. expenditures		1.8	2.8	2.9	2.5	2.7	3.9	5.0	3.6	4.1	1.6
Durables		-8.5	4.4	14.0	-2.4	-0.1	20.6	16.5	3.9	2.2	-0.3
Nondurables		3.8	0.8	-0.6	5.3	5.0	1.6	6.9	5.1	6.7	0.1
Services		3.3	3.5	2.4	2.2	2.1	1.8	1.9	2.8	3.3	2.7
Business fixed investment		-9.7	-9.6	-1.1	-3.2	-0.1	11.8	15.7	11.0	4.2	12.5
Equipment & Software		-6.3	-4.5	4.6	-2.0	4.5	11.0	21.7	12.0	8.0	14.2
Nonres. structures		-18.5	-22.6	-16.0	-6.6	-13.0	14.5	-1.3	7.9	-7.6	6.9
Residential structures		9.3	11.3	2.8	4.2	7.5	9.1	22.4	9.6	5.0	16.5
Exports		4.7	11.0	3.1	-4.2	-1.5	-1.6	11.3	17.5	7.3	7.3
Imports		12.5	11.4	5.4	9.6	-1.9	2.5	2.9	17.1	10.6	12.6
Gov't. cons. & investment		4.7	4.4	2.1	4.0	0.2	7.2	0.1	1.6	2.5	2.2
Federal		8.2	12.8	2.9	9.2	0.3	22.1	-3.3	4.8	7.1	2.7
Defense		5.9	11.4	3.4	13.5	-2.8	38.4	-7.7	11.6	10.6	1.9
State & local		2.9	0.3	1.7	1.4	0.1	-0.5	2.2	-0.1	-0.0	1.9
Change in bus. inventories	Bill. Ch. $	-7.4	7.9	22.7	23.8	9.6	-17.6	-3.5	8.6	40.0	61.1
Nonfarm		-11.9	16.1	24.6	25.3	9.6	-15.7	-2.7	4.6	34.5	58.8
Net exports		-444.9	-458.1	-469.8	-515.4	-511.7	-525.2	-508.7	-528.3	-550.1	-580.3
Nominal GDP	% change	4.4	4.2	3.9	2.7	4.9	5.3	8.8	5.7	7.4	6.6
GDP Gap[1]	%	1.2	1.4	1.6	2.2	2.7	2.6	1.8	1.7	1.4	1.5
Employment and Production											
Nonfarm payroll employment	Millions	130.4	130.4	130.3	130.2	130.0	129.9	129.8	130.0	130.4	131.1
Unemployment rate	%	5.7	5.8	5.7	5.9	5.8	6.1	6.1	5.9	5.6	5.6
Industrial prod. index	% change	2.3	4.4	1.7	-2.3	-0.7	-4.0	4.1	5.7	5.6	4.3
Capacity util. rate - mfg.	%	73.0	73.6	74.0	73.5	73.5	73.0	73.7	74.8	75.6	76.5
Housing starts	Millions	1.72	1.68	1.70	1.74	1.74	1.75	1.88	2.04	1.94	1.92
Light motor vehicle sales		16.60	16.54	17.41	16.60	16.09	16.38	17.23	16.80	16.51	16.54
North Amer. produced		13.29	13.29	14.08	13.31	12.71	13.10	13.89	13.57	13.25	13.14
Other		3.32	3.25	3.32	3.29	3.38	3.28	3.34	3.23	3.26	3.40
Income and Saving											
Nominal GNP	Bill. $	10361.7	10461.6	10571.7	10661.2	10781.3	10929.0	11168.3	11358.1	11546.1	11693.6
Nominal GNP	% change	2.4	3.9	4.3	3.4	4.6	5.6	9.1	7.0	6.8	5.2
Nominal personal income		2.2	4.3	-0.1	1.1	3.8	4.7	4.6	5.3	5.0	6.4
Real disposable income		10.8	2.7	-1.7	0.2	1.8	4.3	8.2	1.4	2.4	2.8
Personal saving rate	%	2.7	2.7	1.6	1.2	1.0	1.1	1.9	1.3	1.0	1.3
Corp. profits, IVA & CCAdj.	% change	24.8	15.2	3.6	19.1	-1.5	36.7	32.0	30.2	13.6	2.9
Profit share of GNP	%	8.1	8.3	8.3	8.6	8.5	9.0	9.5	9.9	10.1	10.0
Excluding FR Banks		7.9	8.1	8.1	8.4	8.3	8.8	9.3	9.8	9.9	9.9
Federal surpl./deficit	Bill. $	-208.5	-251.6	-255.1	-302.7	-281.6	-364.4	-433.0	-379.2	-391.0	-380.0
State & local surpl./def.		-28.8	-23.6	-21.3	-26.3	-49.0	-5.7	6.5	35.3	11.8	18.3
Ex. social ins. funds		-30.8	-25.3	-22.8	-27.6	-50.1	-6.7	5.4	34.1	10.6	16.9
Gross natl. saving rate	%	15.0	14.6	13.7	13.2	12.8	13.1	13.6	14.3	13.6	13.8
Net natl. saving rate		2.9	2.5	1.5	0.9	0.4	0.9	1.6	2.5	2.1	2.3
Prices and Costs											
GDP chn.-wt. price index	% change	1.4	1.5	1.7	2.0	2.7	1.1	1.4	1.6	2.8	3.2
Gross Domestic Purchases chn.-wt. price index		1.2	2.5	1.8	1.9	3.7	0.4	1.7	1.4	3.4	3.5
PCE chn.-wt. price index		0.9	2.9	2.0	1.4	3.2	0.7	1.6	1.2	3.3	3.1
Ex. food and energy		1.2	2.0	2.0	0.9	1.5	1.1	0.9	1.3	2.1	1.7
CPI		1.4	3.4	2.2	2.0	3.8	0.7	2.4	0.7	3.5	4.8
Ex. food and energy		2.1	2.3	2.1	1.7	1.3	1.0	1.5	0.8	1.9	2.9
ECI, hourly compensation[2]		3.6	4.4	2.5	3.3	5.5	3.4	4.4	3.1	4.3	4.0
Nonfarm business sector											
Output per hour		6.9	1.1	4.5	1.6	3.7	6.7	9.0	3.1	3.7	3.9
Compensation per hour		5.5	3.4	1.5	1.2	5.3	5.7	6.1	4.4	2.0	5.9
Unit labor cost		-1.4	2.3	-2.9	-0.3	1.6	-1.0	-2.7	1.2	-1.6	1.9

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

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

Item	Units	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4
			- - - Projected	- - -	- - -	- - -	- - -	- - -	- - -	- - -	- - -
EXPENDITURES											
Nominal GDP	Bill. $	11814.9	11970.7	12120.2	12286.1	12454.6	12618.1	12793.0	12957.2	13120.8	13284.1
Real GDP	Bill. Ch. $	10891.0	10983.9	11086.6	11194.8	11302.9	11407.7	11510.9	11613.6	11716.2	11819.4
Real GDP	% change	4.0	3.5	3.8	4.0	3.9	3.8	3.7	3.6	3.6	3.6
Gross domestic purchases		3.9	4.9	3.2	3.3	3.9	4.0	4.1	3.4	3.8	4.0
Final sales		5.0	2.7	3.5	5.1	4.1	3.6	3.3	4.1	3.5	3.3
Priv. dom. final purchases		5.8	5.0	2.8	4.7	4.3	4.1	4.1	4.1	4.1	4.1
Personal cons. expenditures		5.1	4.6	3.7	4.0	3.8	3.7	3.7	3.7	3.7	3.7
Durables		17.2	4.2	2.7	8.3	6.9	6.0	5.9	6.5	6.4	6.4
Nondurables		4.7	6.0	4.8	4.5	4.4	4.4	4.4	4.4	4.4	4.4
Services		3.0	4.0	3.3	2.9	2.9	2.9	2.9	2.9	2.8	2.8
Business fixed investment		13.0	8.3	-3.2	10.0	9.1	8.4	8.2	8.5	8.5	8.2
Equipment & Software		17.5	11.6	-5.1	12.5	10.7	9.3	9.4	9.9	10.1	9.8
Nonres. structures		-1.1	-2.5	3.2	2.2	3.7	5.3	4.3	3.7	3.1	2.6
Residential structures		1.6	3.9	3.1	4.2	1.5	1.8	1.4	1.1	0.4	1.0
Exports		6.0	-0.8	7.8	8.9	8.4	9.6	6.2	7.4	7.0	8.2
Imports		4.6	9.4	2.4	2.9	6.6	9.3	8.5	4.6	7.5	9.8
Gov't. cons. & investment		0.7	-0.5	3.9	2.9	2.7	2.7	2.4	2.4	2.4	2.5
Federal		4.8	-4.0	6.6	3.7	3.1	2.5	1.7	1.9	1.8	2.1
Defense		10.1	-7.1	8.9	4.9	4.2	3.7	2.0	2.3	2.3	2.8
State & local		-1.7	1.5	2.3	2.5	2.5	2.8	2.8	2.8	2.8	2.8
Change in bus. inventories	Bill. Ch. $	34.5	54.8	62.3	32.6	29.0	33.0	44.0	31.5	33.5	40.9
Nonfarm		30.4	52.0	59.3	29.6	27.0	30.9	41.8	29.4	31.4	38.8
Net exports		-583.2	-624.2	-613.2	-601.1	-605.6	-618.2	-637.6	-636.6	-649.7	-669.7
Nominal GDP	% change	5.5	5.4	5.1	5.6	5.6	5.4	5.7	5.2	5.1	5.1
GDP Gap[1]	%	1.3	1.3	1.2	1.0	0.8	0.6	0.5	0.4	0.3	0.2
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	131.5	132.1	132.7	133.4	134.1	134.9	135.5	136.1	136.7	137.3
Unemployment rate	%	5.5	5.4	5.4	5.3	5.3	5.3	5.3	5.2	5.2	5.1
Industrial prod. index	% change	2.7	4.1	6.6	4.6	5.1	5.1	5.2	4.5	4.0	4.1
Capacity util. rate - mfg.	%	77.0	77.6	78.4	78.8	79.4	80.1	80.7	81.1	81.4	81.8
Housing starts	Millions	1.97	1.96	1.97	1.96	1.95	1.95	1.95	1.94	1.94	1.94
Light motor vehicle sales		17.07	17.20	16.88	17.28	17.50	17.58	17.65	17.79	17.93	18.08
North Amer. produced		13.80	13.56	13.51	13.77	13.98	14.04	14.11	14.23	14.33	14.46
Other		3.27	3.65	3.37	3.51	3.52	3.54	3.54	3.56	3.60	3.62
INCOME AND SAVING											
Nominal GNP	Bill. $	11853.0	11979.2	12135.2	12286.0	12446.0	12600.7	12761.1	12918.3	13070.7	13217.8
Nominal GNP	% change	5.6	4.3	5.3	5.1	5.3	5.1	5.2	5.0	4.8	4.6
Nominal personal income		3.4	9.7	2.8	6.3	6.3	6.3	7.4	6.1	6.0	5.7
Real disposable income		2.0	7.7	0.1	4.4	4.5	4.7	5.8	4.5	4.5	4.2
Personal saving rate	%	0.5	1.2	0.4	0.5	0.7	0.9	1.4	1.6	1.8	1.9
Corp. profits, IVA & CCAdj.	% change	-17.7	37.8	6.4	0.1	0.8	-2.5	0.2	-0.2	-1.8	-3.6
Profit share of GNP	%	9.4	10.1	10.1	10.0	9.9	9.7	9.6	9.5	9.3	9.1
Excluding FR Banks		9.3	10.0	10.0	9.9	9.8	9.6	9.5	9.3	9.2	9.0
Federal surpl./deficit	Bill. $	-384.1	-351.0	-294.3	-272.9	-252.9	-257.2	-312.8	-315.2	-323.1	-325.5
State & local surpl./def.		4.5	8.2	8.3	6.0	7.9	8.6	9.6	9.0	8.8	9.5
Ex. social ins. funds		3.0	6.6	6.7	4.4	6.3	7.0	8.0	7.4	7.2	7.9
Gross natl. saving rate	%	13.5	13.0	13.1	13.2	13.3	13.4	13.3	13.5	13.5	13.5
Net natl. saving rate		1.0	1.5	1.7	1.8	1.9	1.9	1.9	2.1	2.1	2.1
PRICES AND COSTS											
GDP chn.-wt. price index	% change	1.4	1.9	1.3	1.6	1.6	1.5	1.9	1.6	1.5	1.4
Gross Domestic Purchases chn.-wt. price index		1.9	2.4	1.5	1.6	1.4	1.3	1.6	1.3	1.3	1.3
PCE chn.-wt. price index		1.3	2.3	0.9	1.6	1.4	1.4	1.3	1.3	1.3	1.3
Ex. food and energy		0.9	1.4	1.4	1.6	1.6	1.5	1.4	1.4	1.4	1.4
CPI		1.9	3.4	1.0	1.8	1.7	1.6	1.6	1.6	1.6	1.6
Ex. food and energy		1.6	2.3	1.9	2.0	2.0	1.9	1.9	1.9	1.8	1.8
ECI, hourly compensation[2]		3.5	4.1	4.3	4.2	4.2	4.2	4.2	4.2	4.2	4.2
Nonfarm business sector											
Output per hour		1.8	2.1	1.6	1.8	1.7	1.7	1.9	2.1	2.2	2.3
Compensation per hour		3.6	4.4	3.8	4.3	4.3	4.3	4.2	4.2	4.2	4.2
Unit labor cost		1.8	2.3	2.2	2.5	2.6	2.6	2.2	2.0	1.9	1.8

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

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CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

Item	2002 Q3	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	Projected 02Q4/01Q4	Projected 03Q4/02Q4	Projected 04Q4/03Q4
Real GDP	2.6	0.7	1.9	4.1	7.4	4.2	4.5	3.3	4.0	2.3	4.4	3.8
Gross dom. purchases	3.0	2.4	1.8	4.6	6.8	4.9	5.3	4.4	4.1	3.2	4.5	4.7
Final sales	2.0	0.7	2.4	5.1	6.8	3.7	3.3	2.5	5.0	1.2	4.5	3.4
Priv. dom. final purchases	2.1	1.6	2.2	4.3	6.2	4.1	3.6	3.2	4.9	1.4	4.2	4.0
Personal cons. expenditures	2.0	1.7	1.8	2.7	3.6	2.5	2.9	1.1	3.6	1.8	2.7	2.7
Durables	1.2	-0.2	-0.0	1.6	1.4	0.3	0.2	-0.0	1.4	0.1	0.8	0.5
Nondurables	-0.1	1.0	1.0	0.3	1.4	1.0	1.3	0.0	0.9	0.5	0.9	0.9
Services	1.0	0.9	0.9	0.8	0.8	1.2	1.4	1.1	1.3	1.2	0.9	1.4
Business fixed investment	-0.1	-0.3	-0.0	1.1	1.5	1.1	0.4	1.2	1.3	-0.6	0.9	0.9
Equipment & Software	0.3	-0.2	0.3	0.8	1.5	0.9	0.6	1.1	1.3	-0.2	0.9	1.0
Nonres. structures	-0.5	-0.2	-0.3	0.3	-0.0	0.2	-0.2	0.2	-0.0	-0.5	0.0	-0.0
Residential structures	0.1	0.2	0.4	0.4	1.1	0.5	0.3	0.9	0.1	0.3	0.6	0.4
Net exports	-0.4	-1.7	0.1	-0.5	0.6	-0.7	-0.8	-1.1	-0.1	-0.9	-0.1	-0.9
Exports	0.3	-0.4	-0.2	-0.2	1.0	1.6	0.7	0.7	0.6	0.3	0.6	0.5
Imports	-0.7	-1.3	0.3	-0.3	-0.4	-2.2	-1.5	-1.8	-0.7	-1.3	-0.7	-1.3
Government cons. & invest.	0.4	0.8	0.1	1.4	0.0	0.3	0.5	0.4	0.1	0.7	0.4	0.2
Federal	0.2	0.6	0.0	1.4	-0.2	0.3	0.5	0.2	0.3	0.5	0.4	0.2
Defense	0.1	0.5	-0.1	1.5	-0.4	0.5	0.5	0.1	0.5	0.3	0.4	0.2
Nondefense	0.1	0.0	0.2	-0.1	0.1	-0.2	0.0	0.1	-0.1	0.2	-0.0	0.0
State and local	0.2	0.2	0.0	-0.1	0.3	-0.0	0.0	0.2	-0.2	0.2	0.1	0.1
Change in bus. inventories	0.6	0.1	-0.5	-1.0	0.6	0.5	1.2	0.8	-1.0	1.1	-0.1	0.4
Nonfarm	0.4	0.1	-0.5	-0.9	0.5	0.3	1.1	0.9	-1.0	1.0	-0.2	0.4
Farm	0.2	0.0	0.1	-0.1	0.1	0.2	0.1	-0.1	0.1	0.0	0.1	-0.0

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

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CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

	- - - - - - - - - - - - - - - - - - Projected							- - - - - - - - - - - - - - - - -	- - - - Projected		- - - - -
Item	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4	04Q4/ 03Q4	05Q4/ 04Q4	06Q4/ 05Q4
Real GDP	3.5	3.8	4.0	3.9	3.8	3.7	3.6	3.6	3.6	3.8	3.9	3.6
Gross dom. purchases	5.1	3.4	3.5	4.1	4.2	4.3	3.6	4.0	4.2	4.7	3.8	4.0
Final sales	2.7	3.5	5.0	4.0	3.6	3.3	4.0	3.5	3.3	3.4	4.1	3.5
Priv. dom. final purchases	4.3	2.4	4.1	3.7	3.6	3.5	3.6	3.5	3.5	4.0	3.4	3.5
Personal cons. expenditures	3.2	2.6	2.8	2.7	2.6	2.6	2.6	2.6	2.6	2.7	2.7	2.6
Durables	0.4	0.2	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Nondurables	1.2	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Services	1.6	1.4	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.4	1.3	1.2
Business fixed investment	0.8	-0.3	1.0	0.9	0.9	0.8	0.9	0.9	0.9	0.9	0.6	0.9
Equipment & Software	0.9	-0.4	1.0	0.8	0.7	0.7	0.8	0.8	0.8	1.0	0.5	0.8
Nonres. structures	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	-0.0	0.1	0.1
Residential structures	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.1	0.4	0.2	0.1
Net exports	-1.5	0.4	0.4	-0.2	-0.4	-0.7	0.0	-0.4	-0.7	-0.9	0.0	-0.4
Exports	-0.1	0.8	0.9	0.8	1.0	0.6	0.8	0.7	0.8	0.5	0.9	0.7
Imports	-1.4	-0.4	-0.5	-1.0	-1.4	-1.3	-0.7	-1.2	-1.5	-1.3	-0.8	-1.2
Government cons. & invest.	-0.1	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.2	0.6	0.5
Federal	-0.3	0.4	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.3	0.1
Defense	-0.3	0.4	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.2	0.2	0.1
Nondefense	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
State and local	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.1	0.3	0.3
Change in bus. inventories	0.8	0.3	-1.1	-0.1	0.1	0.4	-0.4	0.1	0.3	0.4	-0.2	0.1
Nonfarm	0.8	0.3	-1.1	-0.1	0.1	0.4	-0.4	0.1	0.2	0.4	-0.2	0.1
Farm	-0.0	0.0	0.0	-0.0	0.0	0.0	0.0	0.0	0.0	-0.0	-0.0	0.0

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

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

Item	Fiscal year				2004				2005				2006			
	2003[a]	2004[a]	2005	2006	Q1[a]	Q2[a]	Q3[a]	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
					Not seasonally adjusted											
Unified budget																
Receipts[1]	1782	1880	2082	2223	410	550	479	487	437	636	522	524	470	678	551	536
Outlays[1]	2159	2292	2447	2580	580	576	565	606	620	608	612	633	666	645	636	660
Surplus/deficit[1]	-377	-412	-365	-358	-171	-26	-86	-119	-183	27	-90	-109	-196	32	-85	-125
On-budget	-538	-568	-539	-537	-193	-99	-96	-172	-217	-49	-102	-151	-234	-52	-100	-171
Off-budget	161	155	174	180	23	73	10	53	34	76	12	42	39	84	14	46
Means of financing																
Borrowing	374	378	371	365	136	41	83	103	152	19	98	94	180	-3	94	115
Cash decrease	26	-1	1	0	12	-23	8	12	15	-35	10	10	15	-25	0	10
Other[2]	-22	35	-8	-7	23	8	-6	4	17	-11	-17	5	0	-4	-8	-0
Cash operating balance, end of period	35	36	35	35	21	45	36	25	10	45	35	25	10	35	35	25
					Seasonally adjusted annual rates											
NIPA federal sector																
Receipts	1863	1930	2150	2298	1915	1949	1957	2020	2152	2190	2236	2260	2295	2309	2329	2352
Expenditures	2209	2314	2442	2600	2306	2329	2341	2371	2446	2463	2489	2517	2608	2624	2652	2677
Consumption expenditures	646	694	732	770	691	700	713	709	732	740	747	753	770	776	781	788
Defense	425	469	499	530	465	474	487	480	498	505	511	517	529	534	538	544
Nondefense	221	225	233	241	226	227	226	229	234	235	236	236	241	242	243	244
Other spending	1563	1620	1711	1830	1615	1629	1628	1662	1714	1723	1742	1764	1838	1848	1871	1890
Current account surplus	-345	-384	-293	-302	-391	-380	-384	-351	-294	-273	-253	-257	-313	-315	-323	-326
Gross investment	92	102	108	114	102	104	104	104	107	109	111	113	114	115	116	117
Gross saving less gross investment[3]	-347	-393	-305	-317	-402	-391	-395	-361	-307	-286	-267	-272	-328	-330	-338	-341
Fiscal indicators[4]																
High-employment (HEB) surplus/deficit	-271	-343	-270	-301	-354	-345	-352	-318	-268	-253	-240	-250	-310	-317	-328	-335
Change in HEB, percent of potential GDP	1.2	0.5	-0.7	0.1	0.2	-0.1	0.0	-0.3	-0.4	-0.1	-0.1	0.1	0.4	0.0	0.1	0.0
Fiscal impetus (FI) percent of GDP	1.0	0.9	0.0	0.3	0.2	0.1	0.1	0.1	-0.2	0.1	0.1	0.0	0.1	0.1	0.1	0.0

1. CBO's January 2005 baseline surplus estimates are -$412 billion in FY 2004, -$368 billion in FY 2005 and -$295 billion in FY 2006. Budget receipts, outlays, and surplus/deficit include corresponding social security (OASDI) categories. The OASDI surplus and the Postal Service surplus are excluded from the on-budget surplus and shown separately as off-budget, as classified under current law.
2. Other means of financing are checks issued less checks paid, accrued items, and changes in other financial assets and liabilities.
3. Gross saving is the current account surplus plus consumption of fixed capital of the general government as well as government enterprises.
4. HEB is gross saving less gross investment (NIPA) of the federal government in current dollars, with cyclically sensitive receipts and outlays adjusted to the staff's measure of potential output and the NAIRU. Quarterly figures for change in HEB and FI are not at annual rates. The sign on Change in HEB, as a percent of nominal potential GDP, is reversed. FI is the weighted difference of discretionary changes in federal spending and taxes in chained (2000) dollars, scaled by real GDP. The annual FI estimates are on a calendar year basis. Also, for FI and the change in HEB, positive values indicate aggregate demand stimulus.
a--Actual

Strictly Confidential (FR)
Class II FOMC

Change in Debt of the Domestic Nonfinancial Sectors
(Percent)

January 26, 2005

Period[1]	Total	Federal government	Nonfederal						
			Total	Households			Business	State and local governments	Memo: Nominal GDP
				Total	Home mortgages	Consumer credit			
Year									
1999	6.4	-1.9	8.9	8.3	9.2	7.8	10.7	3.4	6.3
2000	4.9	-8.0	8.3	8.6	8.3	10.7	9.4	1.3	4.6
2001	6.2	-0.2	7.6	8.8	9.7	8.0	6.0	8.9	2.7
2002	6.9	7.6	6.7	9.6	11.9	4.4	2.7	11.1	3.8
2003	8.1	10.9	7.5	10.0	12.4	4.5	4.3	8.2	6.2
2004	7.8	9.0	7.6	9.7	11.6	4.5	5.0	7.3	6.2
2005	7.2	8.2	7.0	8.1	8.9	6.1	6.2	4.0	5.4
2006	6.6	8.1	6.3	6.9	7.4	5.8	6.1	3.1	5.3
Quarter									
2004:1	9.2	12.0	8.6	11.4	13.2	6.2	4.8	10.3	7.4
2	6.9	10.7	6.1	8.5	9.8	1.8	3.6	3.7	6.6
3	7.1	4.9	7.6	9.2	11.4	6.1	5.1	9.3	5.5
4	7.2	7.3	7.2	8.3	9.9	3.5	6.3	5.3	5.4
2005:1	8.3	12.4	7.4	8.5	9.7	5.6	6.2	5.9	5.1
2	7.0	7.9	6.8	8.0	8.7	6.2	6.0	3.4	5.6
3	6.4	5.7	6.6	7.5	8.1	6.2	6.0	3.1	5.6
4	6.3	6.0	6.4	7.2	7.8	6.0	5.9	3.1	5.4
2006:1	7.7	13.9	6.3	7.0	7.5	5.9	6.0	3.1	5.7
2	6.0	5.5	6.2	6.8	7.3	5.8	6.0	3.1	5.2
3	5.9	5.0	6.1	6.6	7.1	5.6	6.0	3.1	5.1
4	6.2	7.2	6.0	6.5	7.0	5.4	6.0	3.1	5.1

Note. Quarterly data are at seasonally adjusted annual rates.
1. Data after 2004:Q3 are staff projections. Changes are measured from end of the preceding period to end of period indicated except for annual nominal GDP growth, which is calculated from Q4 to Q4.

2.6.3 FOF

Strictly Confidential (FR)
Class II FOMC

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

January 26, 2005

Category	2003	2004	2005	2006	2004		2005				2006			
					Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Net funds raised by domestic nonfinancial sectors														
1 Total	1600.6	1536.2	1512.2	1625.8	1440.8	1312.0	1732.7	1492.0	1390.7	1433.4	1883.5	1507.5	1496.4	1616.1
2 Net equity issuance	-57.8	-210.1	-215.0	-81.0	-203.2	-395.2	-264.0	-226.0	-205.0	-165.0	-103.0	-79.0	-71.0	-71.0
3 Net debt issuance	1658.4	1746.3	1727.2	1706.8	1644.0	1707.2	1996.7	1718.0	1595.7	1598.4	1986.5	1586.5	1567.4	1687.1
Borrowing sectors														
Nonfinancial business														
4 Financing gap [1]	-21.1	27.7	-20.5	145.9	-37.3	156.3	-33.9	-38.7	-15.8	6.3	136.5	127.8	146.2	172.9
5 Net equity issuance	-57.8	-210.1	-215.0	-81.0	-203.2	-395.2	-264.0	-226.0	-205.0	-165.0	-103.0	-79.0	-71.0	-71.0
6 Credit market borrowing	303.8	374.1	481.4	508.3	389.2	480.3	482.5	476.0	481.8	485.1	499.2	503.0	511.6	519.5
Households														
7 Net borrowing [2]	840.7	894.8	817.2	758.5	897.3	824.2	867.4	825.2	796.2	780.1	770.7	760.0	752.9	750.5
8 Home mortgages	734.9	769.4	658.8	600.7	800.9	721.5	718.7	663.5	633.6	619.6	610.2	600.9	595.3	596.2
9 Consumer credit	88.4	91.6	131.5	131.7	127.8	73.3	120.7	134.5	136.2	134.6	134.5	133.0	131.4	127.9
10 Debt/DPI (percent) [3]	108.0	112.5	116.5	117.8	113.9	113.6	115.7	116.4	116.9	117.3	117.4	117.7	118.0	118.3
State and local governments														
11 Net borrowing	117.8	114.6	66.2	54.8	150.5	87.9	99.6	57.8	53.8	53.8	54.8	54.8	54.8	54.8
12 Current surplus [4]	176.2	189.3	169.6	176.7	198.4	166.7	168.1	167.1	170.4	172.6	175.0	175.7	177.0	179.1
Federal government														
13 Net borrowing	396.0	362.7	362.4	385.2	207.0	314.9	547.1	358.9	263.9	279.4	661.8	268.7	248.2	362.3
14 Net borrowing (n.s.a.)	396.0	362.7	362.4	385.2	83.4	102.8	151.7	19.2	97.6	93.9	180.3	-3.4	93.7	114.6
15 Unified deficit (n.s.a.)	399.1	400.7	355.0	373.2	85.7	118.6	183.1	-27.3	90.3	108.8	195.7	-32.3	85.3	124.5
Depository institutions														
16 Funds supplied	476.4	671.5	558.3	565.9	438.9	378.3	600.3	500.4	597.0	535.5	647.3	500.4	594.0	522.1
Memo (percentage of GDP)														
17 Domestic nonfinancial debt [5]	194.5	197.3	201.2	204.0	197.9	198.9	200.2	201.3	201.9	202.5	203.2	204.1	204.5	205.1
18 Domestic nonfinancial borrowing	15.1	14.9	14.0	13.1	13.9	14.3	16.5	14.0	12.8	12.7	15.5	12.2	11.9	12.7
19 Federal government [6]	3.6	3.1	2.9	3.0	1.8	2.6	4.5	2.9	2.1	2.2	5.2	2.1	1.9	2.7
20 Nonfederal	11.5	11.8	11.0	10.1	12.2	11.6	12.0	11.1	10.7	10.5	10.4	10.2	10.1	10.0

Note. Data after 2004:Q3 are staff projections.
1. For corporations: Excess of capital expenditures over U.S. internal funds.
2. Includes change in liabilities not shown in lines 8 and 9.
3. Average debt levels in the period (computed as the average of period-end debt positions) divided by disposable personal income.
4. NIPA state and local government saving plus consumption of fixed capital and net capital transfers.
5. Average debt levels in the period (computed as the average of period-end debt positions) divided by nominal GDP.
6. Excludes government-insured mortgage pool securities.
n.s.a. Not seasonally adjusted.

2.6.4 FOF

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International Developments

Although foreign economic growth has slowed somewhat from the first half of 2004, there has been little in recent data to alter our view that the global economy will pick up going forward. The primary causes of the slowdown—higher oil prices and softness in exports resulting from some cooling of high-tech demand and, in some cases, domestic currency appreciation—are expected to abate, and the data suggest that China, in particular, will continue to grow robustly. As a result, projected foreign GDP growth throughout the forecast period is little changed from the December Greenbook.

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

Indicator	2004		Projection				
	H1	Q3	2004: Q4	2005 Q1	2005 Q2	2005 H2	2006
Foreign output	4.1	2.6	3.1	3.0	3.3	3.4	3.3
December GB	*4.1*	*2.7*	*3.1*	*3.0*	*3.2*	*3.2*	*3.2*
Foreign CPI	2.9	2.9	2.3	1.7	2.2	2.2	2.2
December GB	*2.8*	*2.8*	*2.6*	*2.0*	*2.2*	*2.2*	*2.2*

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

The third-quarter slowdown in foreign industrial economies continued into the fourth quarter, but we project their average GDP growth to firm slightly by the middle of 2005. In emerging market economies, average GDP growth is estimated to have picked up to 4¾ percent in the fourth quarter from 3¾ percent in the third quarter and is projected to maintain roughly that pace through the forecast period.

The spot price of West Texas intermediate (WTI) crude oil has risen since late December to around $49 per barrel, about $6 higher than its December average. We now project the spot price will decline to $43 per barrel by the end of the forecast period.

The foreign exchange value of the dollar, although experiencing high day-to-day volatility, has changed little on a trade-weighted basis since the December FOMC meeting. In part reflecting some appreciation between the day of the December Greenbook and the FOMC meeting, the starting point for the projected path of the exchange value of the broad real dollar is 1¼ percent higher than in the previous forecast. From there, we continue to project that the dollar will depreciate at an annual rate of about 1¼ percent over the forecast period because we expect that market concerns about the sustainability of the U.S. external balance will exert downward pressure on the dollar.

Inflation of core import prices increased to an estimated annual rate of 4½ percent in the fourth quarter of 2004, up from 2¼ percent in the third quarter and almost a full percentage point higher than projected in the December Greenbook. This increase likely reflects, at least in part, the sharp decline of the dollar last fall. We project that core import price inflation will move down over the forecast period as the rate of dollar depreciation slows. One risk to the outlook is that, in the wake of the sustained decline in the dollar since early 2002, foreign profit margins may have reached unsustainably low levels and foreign producers may increase the prices of their exports to the United States more than projected. We explore this possibility in an alternative simulation.

Since the December Greenbook, dramatically weak data for U.S. exports, combined with unexpectedly strong U.S. imports, have led us to estimate a substantial negative arithmetic contribution of net exports to GDP growth in the fourth quarter of 2004. Export growth is expected to pick up again in 2005, because of lagged effects of the previous dollar decline and some bounce-back from the fourth-quarter weakness. Import growth is expected to slow, in part reflecting the expiration of partial expensing tax incentives. In consequence, the projected contribution of net exports to GDP growth is about neutral in 2005, but it slides to negative ½ percentage point in 2006 as the effects of previous rapid dollar depreciation play out.

Because of the unexpectedly weak trade data, our estimate of the fourth-quarter 2004 current account balance has deteriorated nearly $40 billion, to $775 billion, 6.5 percent of GDP. This downward revision extends throughout the forecast period, so that in the fourth quarter of 2006, the current account deficit comes to $880 billion, 6.6 percent of GDP.

Oil Prices

After falling to about $40 per barrel in late December, the spot price of WTI crude oil has reversed more than half of the decline from its peak in October, closing at $49.45 per barrel on January 25. Continued strong global oil demand, supply disruptions in Norway and Canada, and OPEC’s apparent willingness to reduce production despite historically high prices have contributed to the rebound in oil prices. In addition, increased violence and sabotage of oil infrastructure in Iraq ahead of elections on January 30 have decreased oil exports to well below pre-war levels. Colder-than-normal temperatures in the United States have also put upward pressure on oil prices.

Our projected path of oil prices, which is in line with quotes from NYMEX futures contracts for light, sweet crude oil, is almost flat through the first half of 2005 and declines thereafter. The current projection calls for the spot price of WTI to fall to $46 per barrel by the fourth quarter of 2005 and $43 per barrel by the fourth quarter of 2006. Relative to the December Greenbook, our projection of the spot price is about $4.60 per barrel higher on average in 2005 and $3.60 per barrel higher in 2006. We have revised our projection of the price of imported oil similarly. Implied volatility of oil futures has remained high, suggesting considerable uncertainty about the path for WTI. In addition, uncertainty about the evolution of the spread between the price of WTI and the average price of imported oil, which has been uncharacteristically high the past few months, is another source of risk to our forecast of the price of imported oil.

International Financial Markets

The trade-weighted exchange value of the dollar, as measured by the staff's nominal major currencies index, rose about 1 percent in the period between the setting of the December Greenbook forecast and the December FOMC meeting; thereafter, it has changed little on balance. Over the intermeeting period, foreign exchange markets were characterized by considerable day-to-day volatility. During the second half of December, the trade-weighted exchange value of the dollar declined 1¾ percent, and at the end of December the nominal major currencies index nearly reached the low set in April 1995. However, the dollar rallied sharply over the remainder of the intermeeting period, primarily against the European currencies, more than reversing the earlier decline in the major currencies index. In the intermeeting period, the dollar has, on balance, appreciated 2 to 3 percent against the major European currencies but has depreciated about 2¼ percent against the yen and ½ percent against the Canadian dollar.

The dollar declined about ¾ percent on a trade-weighted basis against the currencies of our other important trading partners, depreciating against the currencies of several Asian and Latin American emerging market economies.

Our forecast for the broad real dollar incorporates the changes in bilateral exchange rates since the previous Greenbook, while maintaining the staff's earlier projection of an annual depreciation rate of around 1¼ percent over the forecast period. We believe that further dollar depreciation is likely at some point in response to market concerns about the financing burden posed by U.S. external deficits. A continued close market focus on the U.S. current account deficit, combined with the fact that we expect that investors will be surprised by the extent of further widening of that deficit over the forecast period, should limit any potential upward move in the dollar.

Short-term foreign interest rates and benchmark government bond yields were generally unchanged on net over the intermeeting period, reflecting stable official lending rates at the major foreign central banks. Share prices rose about 4 percent in Japan and 2 percent in Europe and did not appear to be affected noticeably by the increase in crude oil spot prices over the intermeeting period.

The central bank of Brazil raised its policy rate 50 basis points in mid-December and again in January in response to continued concerns about inflationary pressures. The EMBI+ spreads of most emerging market debt were little changed on balance and generally remain close to multi-year lows. The monetary authorities of several emerging market economies in East Asia are believed to have intervened heavily in foreign exchange markets over the intermeeting period to offset upward pressures on the exchange values of their currencies.

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

Foreign Industrial Countries

We estimate that the soft patch evident in the third quarter persisted into the fourth quarter for most of the foreign industrial countries, likely reflecting the continued effects of high oil prices, the slowdown in global high-tech production, and domestic currency appreciation. As these effects abate, we expect the average pace of expansion to edge up to around 2½ percent by the middle of this year, with growth in Canada picking up to near potential and the Japanese economy recovering from its recent slump. Growth should continue near that pace over the remainder of the forecast period. We project that twelve-month headline inflation rates in the foreign industrial countries will moderate over the rest of the forecast period, in part reflecting the projected downward path of oil prices.

In Japan, strong data on machinery orders prompted us to mark up our estimate of fourth-quarter growth to 1 percent. In contrast, net exports likely made a negative contribution to GDP growth in the fourth quarter, as exports stagnated and imports rose. In addition, household expenditures, which fell on average in October and November, suggest that consumption continued to be weak. We project exports to recover and the labor market to improve gradually. As a result, we forecast an increase in consumption and a pick-up in GDP growth to an annual rate of 1¾ percent by mid-2006. Twelve-month CPI inflation is projected to turn positive on a sustained basis in 2006, and we have penciled in a slight rise in policy rates around that time, when we assume that the BOJ will begin exiting from quantitative easing.

We estimate that euro-area growth edged up in the fourth quarter. Recent data show an improvement in French consumption, although the German economy appears to have remained very weak. We project that real GDP growth in the euro area will remain around 1½ percent in 2005 and 2006. We expect twelve-month inflation, boosted by higher oil and administered prices, to remain at or above 2 percent in the first half of 2005 before moving down to 1¾ percent by 2006. We assume that the European Central Bank will raise its official rates 25 basis points later this year and tighten further in 2006.

According to the preliminary estimate, U.K. GDP rose at an annual rate of 3 percent in the fourth quarter. The service sector is estimated to have expanded robustly. However, housing prices were flat on balance over the fourth quarter, and retail sales contracted in December. The pace of expansion is projected to slow to around its estimated potential rate of 2½ percent during 2005 before slipping a bit further in 2006, when government spending slows. We assume that the Bank of England will keep monetary policy on hold over the forecast period. This stance should be sufficient to prevent inflation from moving above the target rate of 2 percent.

In Canada, October GDP (based on industry data) was flat, which, along with slower external demand, points to a step-down in Canadian GDP growth in the fourth quarter to around 2 percent. We project that consumption and investment will continue to expand, which should help bring growth back to around its estimated potential rate (just over 3 percent) by the second quarter of this year and keep it there over the rest of the forecast period. We assume a further 100 basis points of monetary policy tightening over the forecast period starting in the second half of this year. After falling to around 1½ percent in mid-2005, inflation is projected to return to around the 2 percent midpoint of the Bank of Canada's inflation target range.

Other Economies

Slowing from rates in the first half of last year, average real GDP growth in the emerging-market economies is estimated to have moved to 4¾ percent in the fourth quarter of 2004 from 3¾ percent in the third quarter. We project average growth to roughly maintain the fourth-quarter pace over the forecast period.

Real GDP growth in emerging Asia is estimated to have averaged 5½ percent in the fourth quarter, up from 4¾ percent in the third quarter. Output in China accelerated to a rate of 11 percent, nearly 4 percentage points higher than shown in the December Greenbook. Although investment decelerated sharply in the quarter, export growth was very high. We project some slowing in Chinese growth over the forecast period, to an average rate of about 7¼ percent. However, there is a significant risk that growth will be higher than projected in the near term, followed by a larger slowdown later as the authorities attempt to avoid overheating.

Elsewhere in the region, growth is estimated to have firmed to an average pace of about 4 percent in the fourth quarter from 3¼ percent in the third quarter, putting second-half growth considerably below the average pace of 6 percent in the first half. This decline results from higher oil prices and a slowdown in high-tech demand. We expect growth in these economies to pick up a bit more, to an average pace of about 4¼ percent over the forecast period, as we project that oil prices will decline somewhat and high-tech demand will improve. The adverse macroeconomic effects of the tsunami have so far been small and transitory for most major developing Asian economies, because the devastation did not hit industry and infrastructure in the more economically important areas. We expect the reconstruction efforts to lead to a pickup in investment in 2005.

We estimate that real GDP in Latin America grew 4 percent in the fourth quarter, up a percentage point from the third quarter, reflecting a rebound in Mexican growth. Our projection that growth in the region will stay at about 4 percent over the forecast period is unchanged from the December Greenbook. We project growth in Mexico will edge up to about 4¼ percent over the forecast period, tracking the forecast for U.S. manufacturing production. This path is slightly stronger than the one in the previous Greenbook because of the higher price of oil and upgrade in the outlook for U.S. manufacturing production.

We expect four-quarter inflation for developing countries to decline from 4 percent in 2004 to 3 percent in 2005. In addition to the effects of softer oil prices, the decline in 2005 is heavily influenced by a fall in food prices in China. Inflation in developing Asia is expected to be only 2¼ percent by the end of the forecast period. In Latin America, monetary policy restraint in Brazil and Mexico is expected to lead to a decline in inflation to 4¼ percent by the end of 2006.

Prices of Internationally Traded Goods

For the fourth quarter of 2004, core import prices are estimated to have increased at an annual rate of 4½ percent. The pick-up in core import price inflation from 2¼ percent in the third quarter likely reflects, in part, the sharp decline in the dollar last fall. Because of strong November and December BLS price data that were released after the December Greenbook, our estimate for core import inflation is almost a full percentage point higher than the previous forecast. The BLS data showed sharp increases in prices of imported industrial supplies (reflecting higher prices for natural gas, metals, and building materials) and of foods, feeds, and beverages. Additionally, import price inflation for manufactured goods picked up in the fourth quarter after remaining quite low in the two preceding quarters.

In the first quarter of 2005, core import prices are expected to increase 3¼ percent (a.r.), as the lagged effects of the dollar's previous decline continue to be felt. Although the dollar has risen slightly since the last Greenbook, the recent strength in reported import price inflation has caused us to raise our projection for first-quarter core import price inflation ½ percentage point relative to the previous forecast. With only modest projected declines in the dollar and with commodity prices having flattened out, import price inflation should move down to less than 1 percent for the rest of 2005 and to nearly zero in 2006. The expiration of the Multifibre Arrangement in January is expected to lead to a substantial fall in imported apparel prices, as China increases market share, and to depress core import price inflation more than ½ percentage point in the second half of 2005 and in 2006.

In the fourth quarter, core export prices are estimated to have increased 5½ percent, up from a rise of less than 2 percent in the third quarter. The rise in inflation between the third and fourth quarters resulted from increased inflation for exported industrial supplies (including chemicals, metals, and petroleum products) and more modest declines in prices for exported agricultural products. In the first quarter of 2005, we project that core export price inflation will move down to 2¼ percent, largely because of direct and indirect effects of the projected decline in prices for refined petroleum products. Thereafter, core export price inflation is projected to move in line with U.S. producer price inflation.

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

Indicator	2004		Projection				
	H1	Q3	2004: Q4	2005 Q1	2005 Q2	2005 H2	2006
Exports							
Core goods	6.9	1.9	5.4	2.2	2.3	1.8	2.3
Imports							
Non-oil core goods	5.2	2.3	4.4	3.3	.8	.6	.2
Oil (dollars per barrel)	34.55	37.54	40.60	41.57	42.46	41.24	39.59

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.

Trade in Goods and Services

Since the December Greenbook we have received trade data for October and November. Nominal imports of goods and services grew briskly in both these months after declining slightly in September. Real imports of goods and services are now estimated to have climbed almost 9½ percent in the fourth quarter, up from relatively subdued growth of 4½ percent in third quarter. This estimate is about 1¾ percentage points higher than in the December Greenbook, reflecting stronger-than-anticipated data. While much of the pickup in import growth from its third-quarter pace resulted from a surge in real oil imports, strength was widespread across different categories of core imports as well, despite rising import prices.

In the first two quarters of 2005, real import growth is projected to slow to below 3 percent, as oil import growth drops back precipitously and as capital goods imports weaken in response to the expiration of partial expensing tax incentives. Largely as a consequence, total real import growth is expected to moderate to about 5¼ percent in 2005, following growth of 9¼ percent in 2004. This projection is about ¾ percentage points lower than in the December Greenbook, mainly reflecting the impact of slightly higher core import prices on core imports, as well as a decrease in our projection for real oil imports. Real import growth is projected to pick up to over 7½ percent in 2006, as oil imports bottom out and imports of core goods and services accelerate. The pickup in imports of core goods reflects the recovery of capital goods imports as well as the waning impact of sizeable recent increases in core import prices. Similarly, imports of services accelerate with the diminishing effect of the recent sharp rise in their prices, which have been boosted by the fall in the dollar late last year.

Nominal exports increased slightly in October before plummeting in November. The unexpectedly weak data led us to revise our forecast of real exports down to a decline of ¾ percent in the fourth quarter, a dramatic markdown from the 10¼ percent growth projected in the December Greenbook. Although services and high-tech exports also were disappointing, the shortfall in overall exports came primarily from an estimated 5 percent falloff in real core exports, with weakness widespread within this category. Because none of the fundamental determinants of exports moved in such a way as to explain the negative surprise, we see no reason to carry this weakness forward in our projection. Accordingly, we expect a portion of the shortfall to be made up subsequently, and real exports are projected to grow 7¾ percent in the first quarter, up 1¼ percentage points from the December Greenbook.

In 2005 as a whole, real export growth is expected to pick up to 8¾ percent. This rise reflects both the first-quarter bounce-back—which explains the upward revision in the forecast for this year—and the lagged effects of the previous decline in the dollar on core exports and services. As the positive effect of the lower dollar dissipates, reducing support for exports of core goods and services, real export growth is expected to moderate to 7¼ percent in 2006. This growth is a bit lower than in the December Greenbook, reflecting the higher projected path for the dollar. Foreign GDP growth remains steady throughout the forecast period, and thus has little impact on the pattern of export growth.

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

Indicator	2004		Projection				
	H1	Q3	2004: Q4	2005 Q1	2005 Q2	2005 H2	2006
Real exports	7.3	6.0	-.8	7.8	8.9	9.0	7.2
December GB	*7.3*	*6.3*	*10.2*	*6.5*	*8.5*	*9.2*	*7.6*
Real imports	11.6	4.6	9.4	2.4	2.9	7.9	7.6
December GB	*11.6*	*6.0*	*7.6*	*4.4*	*3.1*	*8.1*	*8.1*

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

Alternative Simulation

Despite a 15 percent depreciation of the dollar on a real trade-weighted basis since early 2002, the upward pressure on import prices has been relatively modest. However, it is possible that foreign profit margins may have reached unsustainably low levels and that foreign producers will increase the prices of their exports to the United States more than in the baseline forecast. Accordingly, in our alternative scenario, we consider the effects of an exogenous rise in U.S. core import prices, beginning in the first quarter of 2005, that raises import prices by 5 percent relative to baseline by the end of this year.

The rise in import prices boosts U.S. real GDP growth roughly 0.4 percentage point above baseline in 2005 and 2006. Real GDP rises because higher import prices induce expenditure switching toward relatively cheaper U.S.-produced goods and because real exports increase as foreign producers spend on U.S. goods some of their increased revenues. The import-price hike boosts core consumer price inflation about 0.3 percentage point in 2005 and a bit less in 2006. Although higher import prices induce an immediate expansion of the trade deficit of 0.4 percentage point of GDP relative to baseline, this deterioration is largely reversed after a year by the gradual fall in real imports and modest export expansion.

Alternative Simulation:
The Effect of Higher U.S. Import Prices
(Percent change from previous period, annual rate)

Indicator and simulation	2005		2006	
	H1	H2	H1	H2
U.S. real GDP				
Baseline	3.9	3.8	3.6	3.6
Higher import prices	4.1	4.3	4.1	4.0
U.S. PCE prices excluding food and energy				
Baseline	1.5	1.6	1.4	1.4
Higher import prices	2.0	1.8	1.6	1.5
U.S. trade balance (share of GDP)				
Baseline	-5.6	-5.4	-5.4	-5.4
Higher import prices	-6.0	-5.6	-5.5	-5.5

Note. H1 is Q2/Q4; H2 is Q4/Q2. In these simulations, the nominal federal funds rate remains unchanged from baseline, and the monetary authorities in major foreign economies adjust their policy rates according to a Taylor rule.

Strictly Confidential (FR)
Class II FOMC

January 26, 2005

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

							-----Projected----		
Measure and country	1998	1999	2000	2001	2002	2003	2004	2005	2006
REAL GDP (1)									
Total foreign	1.5	5.0	4.2	0.3	3.0	2.8	3.5	3.3	3.3
Industrial Countries	2.7	4.4	3.5	0.8	2.6	1.6	2.4	2.4	2.4
of which:									
Canada	4.4	5.9	4.1	1.4	3.8	1.7	3.0	3.0	3.0
Japan	-1.2	0.1	3.2	-2.0	1.4	2.0	1.8	1.4	1.8
United Kingdom	2.8	3.3	3.0	2.2	1.9	2.7	2.8	2.5	2.2
Euro Area (2)	2.0	3.9	2.7	0.8	1.1	0.8	1.7	1.5	1.6
Germany	0.7	3.3	1.9	0.5	0.5	0.0	1.1	1.0	1.3
Developing Countries	-0.3	6.0	5.3	-0.4	3.5	4.4	5.2	4.6	4.5
Asia	-2.2	8.6	5.9	0.9	5.8	6.2	5.8	5.0	5.0
Korea	-5.4	11.4	4.5	4.7	7.7	4.1	2.8	3.9	4.2
China	9.8	7.0	7.6	6.9	8.3	10.0	9.5	7.1	7.5
Latin America	1.2	4.2	4.4	-1.3	1.4	2.3	4.5	4.1	4.2
Mexico	2.9	5.4	4.8	-1.2	1.9	2.0	4.1	4.1	4.3
Brazil	-1.7	3.5	3.9	-0.9	4.2	0.8	4.9	3.0	3.0
CONSUMER PRICES (3)									
Industrial Countries	0.9	1.1	1.7	0.9	2.1	1.3	1.7	1.2	1.4
of which:									
Canada	1.1	2.4	3.1	1.1	3.9	1.7	2.3	1.6	2.0
Japan	0.7	-1.1	-1.2	-1.3	-0.5	-0.4	0.3	-0.5	0.2
United Kingdom (4)	1.4	1.2	1.0	1.0	1.5	1.3	1.4	1.8	1.8
Euro Area (2)	0.9	1.5	2.5	2.1	2.3	2.1	2.3	1.8	1.7
Germany	0.3	1.1	1.7	1.5	1.2	1.2	2.1	1.1	0.7
Developing Countries	9.0	4.6	4.1	2.8	2.9	3.0	3.9	3.1	3.0
Asia	4.4	0.1	1.8	1.1	0.7	2.1	3.0	2.4	2.3
Korea	5.8	1.2	2.6	3.4	3.4	3.5	3.4	4.0	3.3
China	-1.2	-1.0	0.9	-0.1	-0.6	2.6	3.2	1.7	1.9
Latin America	15.4	12.5	8.4	5.3	6.4	5.0	5.6	4.3	4.2
Mexico	17.3	13.5	8.7	5.1	5.3	3.9	5.3	3.8	3.8
Brazil	2.0	8.4	6.4	7.5	10.7	11.5	7.2	5.7	5.1

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.

Strictly Confidential (FR) January 26, 2005
Class II FOMC

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

Measure and country	2004 Q1	2004 Q2	2004 Q3	2004 Q4	Projected 2005 Q1	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4
REAL GDP (1)	Quarterly changes at an annual rate											
Total foreign	4.7	3.6	2.6	3.1	3.0	3.3	3.3	3.4	3.3	3.3	3.3	3.3
Industrial Countries	3.2	2.5	1.9	2.0	2.1	2.4	2.5	2.6	2.4	2.4	2.4	2.4
of which:												
Canada	2.7	3.9	3.2	2.2	2.6	2.9	3.2	3.3	3.1	3.1	3.0	3.0
Japan	6.8	-0.6	0.2	1.0	1.2	1.4	1.5	1.6	1.7	1.8	1.8	1.8
United Kingdom	3.0	3.5	1.8	3.0	2.1	2.6	2.6	2.6	2.3	2.2	2.2	2.2
Euro Area (2)	2.7	1.9	1.1	1.4	1.4	1.5	1.6	1.6	1.6	1.6	1.6	1.6
Germany	1.7	1.7	0.4	0.6	0.8	1.0	1.1	1.2	1.2	1.2	1.3	1.3
Developing Countries	7.0	5.1	3.8	4.8	4.4	4.6	4.6	4.6	4.6	4.6	4.5	4.5
Asia	8.0	5.1	4.8	5.5	4.8	5.2	5.0	5.0	5.0	5.0	5.0	5.0
Korea	3.0	2.6	2.6	3.0	3.5	4.0	4.0	4.2	4.3	4.2	4.2	4.2
China	14.4	2.8	10.1	11.2	7.1	7.1	7.1	7.1	7.5	7.5	7.5	7.5
Latin America	6.1	4.9	2.9	4.0	4.0	4.0	4.1	4.2	4.2	4.2	4.2	4.1
Mexico	5.5	4.5	2.6	4.0	4.0	4.1	4.2	4.3	4.4	4.4	4.3	4.2
Brazil	7.5	5.5	4.2	2.5	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
CONSUMER PRICES (3)	Four-quarter changes											
Industrial Countries	0.8	1.6	1.5	1.7	1.7	1.4	1.5	1.2	1.3	1.4	1.4	1.4
of which:												
Canada	0.8	2.2	2.0	2.3	2.3	1.7	1.9	1.6	1.7	1.9	2.0	2.0
Japan	-0.3	-0.2	-0.2	0.3	-0.2	-0.2	-0.0	-0.5	-0.0	0.1	0.2	0.2
United Kingdom (4)	1.2	1.4	1.3	1.4	1.6	1.8	1.9	1.8	1.7	1.7	1.8	1.8
Euro Area (2)	1.7	2.3	2.3	2.3	2.4	2.1	2.0	1.8	1.8	1.8	1.7	1.7
Germany	1.0	1.9	2.0	2.1	2.1	1.7	1.5	1.1	1.1	0.9	0.8	0.7
Developing Countries	3.0	3.7	4.5	3.9	3.6	3.3	2.8	3.1	3.2	3.1	3.1	3.0
Asia	2.3	3.4	4.3	3.0	2.8	2.2	1.6	2.4	2.5	2.4	2.4	2.3
Korea	3.3	3.4	4.3	3.4	3.5	4.1	3.5	4.0	3.9	3.7	3.6	3.3
China	2.8	4.4	5.3	3.2	2.6	1.4	0.6	1.7	2.0	1.9	1.9	1.9
Latin America	4.7	4.6	5.2	5.6	5.2	5.3	4.9	4.3	4.4	4.4	4.3	4.2
Mexico	4.3	4.3	4.8	5.3	4.8	4.9	4.5	3.8	4.0	4.0	4.0	3.8
Brazil	6.8	5.5	6.8	7.2	7.2	7.0	6.1	5.7	5.2	5.2	5.1	5.1

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

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

							------ Projected	------	------
	1998	1999	2000	2001	2002	2003	2004	2005	2006
NIPA REAL EXPORTS and IMPORTS									
	Percentage point contribution to GDP growth, Q4/Q4								
Net Goods & Services	-1.1	-1.0	-0.9	-0.2	-0.9	-0.1	-0.9	0.0	-0.4
Exports of G&S	0.3	0.6	0.7	-1.3	0.3	0.6	0.5	0.9	0.7
Imports of G&S	-1.4	-1.6	-1.6	1.1	-1.3	-0.7	-1.3	-0.8	-1.2
	Percentage change, Q4/Q4								
Exports of G&S	2.6	5.6	6.5	-11.9	3.5	6.1	4.9	8.7	7.2
Services	4.4	5.3	1.8	-8.9	9.8	3.8	4.6	6.7	5.9
Computers	7.3	13.4	22.7	-23.5	-1.0	11.2	2.5	14.8	14.4
Semiconductors	9.5	34.6	27.6	-34.6	9.9	38.8	-3.9	26.5	29.1
Other Goods 1/	1.2	3.3	5.9	-10.2	0.4	5.0	5.8	8.2	6.2
Imports of G&S	11.0	12.1	11.2	-7.6	9.7	4.9	9.3	5.2	7.6
Services	10.4	6.5	10.7	-5.9	8.9	3.7	1.7	3.8	4.5
Oil	4.2	-3.4	13.3	3.7	4.2	1.8	9.9	-5.7	1.8
Computers	26.4	26.0	13.9	-13.6	13.4	16.9	21.6	13.7	17.5
Semiconductors	-7.7	34.2	22.8	-51.1	10.0	0.3	14.1	22.1	29.1
Other Goods 2/	11.2	12.9	10.5	-6.5	9.9	4.9	10.0	6.7	8.2
	Billions of Chained 2000 Dollars								
Net Goods & Services	-203.8	-296.2	-379.5	-399.1	-472.1	-518.5	-584.5	-609.5	-648.4
Exports of G&S	966.5	1008.2	1096.3	1036.7	1012.4	1031.8	1117.5	1187.7	1279.6
Imports of G&S	1170.3	1304.5	1475.8	1435.8	1484.4	1550.2	1702.0	1797.3	1927.9
	Billions of dollars								
US CURRENT ACCOUNT BALANCE	-209.6	-296.8	-413.5	-385.7	-473.9	-530.7	-669.9	-781.3	-848.3
Current Acct as Percent of GDP	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-5.7	-6.3	-6.5
Net Goods & Services (BOP)	-164.9	-263.3	-378.4	-362.7	-421.7	-496.5	-617.3	-681.8	-704.8
Investment Income, Net	8.3	18.4	25.3	28.7	12.6	38.8	26.1	-14.2	-58.2
Direct, Net	65.5	78.2	94.9	115.9	100.8	118.9	129.4	142.2	150.2
Portfolio, Net	-57.2	-59.8	-69.7	-87.2	-88.2	-80.1	-103.2	-156.3	-208.4
Other Income & Transfers,Net	-53.0	-52.0	-60.4	-51.7	-64.8	-72.9	-78.8	-85.3	-85.3

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

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	2001				2002				2003			
	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	0.5	-0.6	-0.7	-1.1	-0.5	-0.4	-1.7	0.1	-0.5	0.6	-0.7
Exports of G&S	-0.6	-1.4	-2.0	-1.1	0.4	1.0	0.3	-0.4	-0.2	-0.2	1.0	1.6
Imports of G&S	0.6	1.9	1.5	0.5	-1.5	-1.4	-0.7	-1.3	0.3	-0.3	-0.4	-2.2
Percentage change from previous period, s.a.a.r.												
Exports of G&S	-5.3	-12.7	-18.2	-10.8	4.7	11.0	3.1	-4.2	-1.5	-1.6	11.3	17.5
Services	-5.0	-0.6	-13.7	-15.3	21.7	4.5	3.5	10.5	-12.7	-3.5	14.1	20.6
Computers	-9.8	-35.7	-24.9	-21.3	-20.4	11.9	-3.8	12.3	-4.5	-3.4	38.2	19.8
Semiconductors	-30.0	-54.0	-45.3	3.7	24.9	38.8	11.4	-24.4	40.9	28.0	40.8	45.9
Other Goods 1/	-2.5	-11.5	-17.6	-8.6	-2.1	12.6	2.7	-10.3	2.4	-2.4	6.6	13.9
Imports of G&S	-3.7	-12.6	-10.3	-3.4	12.5	11.4	5.4	9.6	-1.9	2.5	2.9	17.1
Services	-5.1	12.9	-18.3	-10.4	24.6	-5.7	2.8	16.5	-2.4	-9.4	17.9	11.0
Oil	63.5	-33.8	-28.2	49.1	-5.6	-17.5	-10.8	69.9	-6.0	-2.8	0.6	16.6
Computers	-22.6	-23.3	-13.4	8.4	50.2	7.2	2.6	0.2	7.0	15.9	12.0	34.2
Semiconductors	-43.9	-70.1	-55.4	-23.7	42.3	33.9	-6.7	-17.6	-4.0	2.4	-1.5	4.4
Other Goods 2/	-5.5	-10.6	-3.7	-5.9	8.3	19.4	8.5	4.1	-1.8	5.5	-0.9	17.9
Billions of Chained 2000 Dollars, s.a.a.r.												
Net Goods & Services	-398.2	-385.2	-398.4	-414.6	-444.9	-458.1	-469.8	-515.4	-511.7	-525.2	-508.7	-528.3
Exports of G&S	1097.2	1060.6	1008.7	980.3	991.6	1017.8	1025.5	1014.5	1010.6	1006.5	1033.8	1076.2
Imports of G&S	1495.4	1445.8	1407.1	1394.9	1436.5	1475.9	1495.3	1529.8	1522.3	1531.7	1542.5	1604.5
Billions of dollars, s.a.a.r.												
US CURRENT ACCOUNT BALANCE	-426.8	-390.2	-367.6	-358.3	-440.8	-471.6	-476.0	-507.4	-552.8	-535.5	-526.5	-507.8
Current Account as % of GDP	-4.3	-3.9	-3.6	-3.5	-4.3	-4.5	-4.5	-4.8	-5.1	-4.9	-4.7	-4.5
Net Goods & Services (BOP)	-389.3	-356.1	-357.1	-348.3	-375.0	-413.5	-427.7	-470.7	-501.6	-493.5	-489.0	-502.0
Investment Income, Net	23.9	29.8	1.5	59.7	9.2	1.8	10.6	28.8	21.5	29.1	34.5	70.1
Direct, Net	106.2	116.1	95.0	146.2	100.6	95.1	94.9	112.8	101.3	105.4	114.6	154.2
Portfolio, Net	-82.3	-86.3	-93.5	-86.6	-91.4	-93.2	-84.3	-84.0	-79.8	-76.3	-80.1	-84.1
Other Inc. & Transfers, Net	-61.3	-63.9	-12.0	-69.7	-75.0	-59.9	-59.0	-65.4	-72.8	-71.0	-72.0	-76.0

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

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	2004				Projected 2005				Projected 2006			
	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	-0.8	-1.1	-0.1	-1.5	0.4	0.4	-0.2	-0.4	-0.7	0.0	-0.4	-0.7
Exports of G&S	0.7	0.7	0.6	-0.1	0.8	0.9	0.8	1.0	0.6	0.8	0.7	0.8
Imports of G&S	-1.5	-1.8	-0.7	-1.4	-0.4	-0.5	-1.0	-1.4	-1.3	-0.7	-1.2	-1.5
Percentage change from previous period, s.a.a.r.												
Exports of G&S	7.3	7.3	6.0	-0.8	7.8	8.9	8.4	9.6	6.2	7.4	7.0	8.2
Services	3.4	10.2	-1.9	7.1	7.0	6.9	6.6	6.3	6.1	6.0	5.8	5.6
Computers	-8.3	-1.8	22.4	0.3	16.5	14.1	14.3	14.3	14.4	14.4	14.4	14.4
Semiconductors	12.5	-10.1	-20.7	6.6	19.3	28.5	29.2	29.2	29.1	29.1	29.1	29.1
Other Goods 1/	10.1	7.7	11.1	-4.9	6.9	8.5	7.7	9.8	4.6	6.4	6.0	8.0
Imports of G&S	10.6	12.6	4.6	9.4	2.4	2.9	6.6	9.3	8.5	4.6	7.5	9.8
Services	1.1	10.7	2.8	-7.0	2.5	3.4	4.3	4.8	4.7	4.6	4.5	4.5
Oil	39.0	-33.1	2.2	53.5	-5.5	-26.6	-4.6	19.6	11.4	-23.5	0.4	25.6
Computers	12.8	38.6	29.9	7.5	4.1	16.7	17.3	17.3	17.5	17.5	17.5	17.5
Semiconductors	42.2	21.2	7.4	-8.5	4.1	28.2	28.8	29.2	29.1	29.1	29.1	29.1
Other Goods 2/	8.9	19.6	3.7	8.3	3.7	7.3	7.9	8.0	8.1	8.2	8.3	8.3
Billions of Chained 2000 Dollars, s.a.a.r.												
Net Goods & Services	-550.1	-580.3	-583.2	-624.2	-613.2	-601.1	-605.6	-618.2	-637.6	-636.6	-649.7	-669.7
Exports of G&S	1095.4	1114.8	1131.1	1128.9	1150.2	1175.0	1199.0	1226.8	1245.5	1267.9	1289.5	1315.3
Imports of G&S	1645.5	1695.1	1714.3	1753.1	1763.4	1776.1	1804.5	1845.0	1883.1	1904.4	1939.2	1985.1
Billions of dollars, s.a.a.r.												
US CURRENT ACCOUNT BALANCE	-588.7	-657.6	-658.8	-774.4	-774.8	-770.3	-780.4	-799.6	-838.3	-827.2	-846.9	-880.7
Current Account as % of GDP	-5.1	-5.6	-5.6	-6.5	-6.4	-6.3	-6.3	-6.3	-6.6	-6.4	-6.5	-6.6
Net Goods & Services (BOP)	-554.4	-604.3	-621.4	-688.9	-686.1	-676.4	-677.4	-687.5	-702.6	-694.4	-702.5	-719.7
Investment Income, Net	54.3	26.3	26.8	-2.8	3.7	-11.4	-20.0	-28.9	-43.3	-50.3	-61.5	-77.7
Direct, Net	139.1	125.1	125.6	127.7	139.7	142.5	142.8	143.7	141.8	147.9	154.5	156.7
Portfolio, Net	-84.8	-98.8	-98.8	-130.6	-136.1	-154.0	-162.8	-172.5	-185.1	-198.2	-216.0	-234.4
Other Inc. & Transfers, Net	-88.5	-79.5	-64.3	-82.7	-92.4	-82.5	-82.9	-83.3	-92.4	-82.5	-82.9	-83.3

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