Prefatory Note

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Strictly Confidential (FR) Class II FOMC

Part 1

March 16, 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

The economy has been expanding more rapidly than we envisioned in the January Greenbook. The most recent data suggest that real GDP rose at an annual rate of 4¼ percent in the fourth quarter of last year, and we now look for growth to be near that pace in the current quarter; those figures are, on average, more than ½ percentage point above our January projections. The most striking upward revision has been in business spending on equipment and software: In that category of spending, the apparent continuation of solid growth into the current quarter has led us to scale back considerably our estimate of the influence of the partial-expensing tax incentives and to conclude that more of the recent strength has reflected greater underlying demand that is likely to persist for a time. In addition, favorable incoming news on labor market conditions, upward revisions to income in the second half of last year, and higher equity prices, on net, since the January Greenbook all point to stronger growth going forward than we had earlier anticipated. That said, not all incoming economic news has pointed to stronger real activity in the period ahead. Most notably, spot prices for oil have backed up sharply, and participants in futures markets expect these prices to remain elevated for quite some time.

On net, the economy seems to have more thrust going forward then we had earlier anticipated. Furthermore, the news on inflation has been mildly disappointing. Accordingly, we have conditioned this forecast on a steeper path for the federal funds rate relative to the January Greenbook. We also have revised various elements of our aggregate supply assumptions, a revision that, all else being equal, boosts GDP growth slightly this year and next. Taken together, those revisions led to our projection that real GDP will rise 4 percent this year and 3½ percent in 2006, which is little changed from the January Greenbook. We continue to expect that, with this growth path, the slack in labor and product markets will be nearly eliminated by the end of the projection period.

The recent data on core consumer price inflation have come in slightly above our expectations, and the higher path of consumer energy prices implies that headline inflation will recede more gradually than we had been projecting in January. Firms' costs have also risen as a result of the higher energy prices as well as higher prices for some other industrial commodities and imports. In addition, inflation compensation implied by TIPS yields over the next five years has moved up further. However, survey measures of expected inflation have not increased. Moreover, information on labor compensation—by far the largest portion of business costs—has not been unfavorable on balance, and productivity growth has been sufficiently strong to lead us to raise our estimate of structural productivity growth. Thus, structural unit labor costs look to be coming in lower than was anticipated in the January Greenbook. Finally, we expect the contributions of energy prices and import prices to core inflation to wane over the forecast period. In all, we have raised our projection for core consumer price inflation just a couple of tenths, and we expect core PCE price inflation to be around 1¾ percent this year and to edge lower to just above 1½ percent in 2006.

Key Background Factors

The forecast is now conditioned on a federal funds rate that reaches 3½ percent in the fourth quarter of this year and 4 percent in the fourth quarter of 2006; both figures are 50 basis points higher than we assumed in the January Greenbook. Market expectations for the funds rate have been revised up by a similar amount. Thus, the staff's assumed policy path remains only ¼ percentage point below the market's, on average, over the projection period. Given the upward shift in market expectations for the funds rate, rates on longer-term securities have moved up between 10 basis points and 35 basis points since the time of the January Greenbook; we have carried those upward revisions through the forecast period.

Broad equity market indexes currently stand about 2 percent above the level we had assumed in the January Greenbook, and we have raised our path for stock prices by this amount throughout the projection period. We continue to assume that, beyond the current quarter, share prices will rise at an annual rate of 6½ percent, maintaining risk-adjusted parity with the yield on long-term bonds. Our projection for house prices is little changed from the January Greenbook and calls for increases in the OFHEO repeat-transactions index to slow from 11 percent in 2004 to about 5 percent this year and 3½ percent in 2006.

Our fiscal assumptions also are little changed. Both receipts and defense expenditures have come in about as expected since January, and the defense supplemental bill also appears to be in line with our assumptions. However, given our reconsideration of the effects of the partial-expensing tax incentives, which we now believe to be imposing little restraint in 2005, we now judge overall federal budget policy to provide a small stimulus to GDP growth this year rather than to be about neutral as we assumed in January. We continue to believe that the introduction of the new Medicare drug benefit will provide a small positive impetus to growth in 2006. We project the unified federal deficit to be near $380 billion in both fiscal 2005 and fiscal 2006—a somewhat higher deficit than in the January Greenbook because changes in some technical assumptions offset the influence of the upward revisions to GDP and corporate profits.

Oil prices have moved notably higher in recent weeks, and we have raised our projection considerably. The spot price of West Texas intermediate (WTI) crude oil now stands near \$55 per barrel, close to its highs last October, and far-dated futures prices have moved up to about \$46 per barrel. The rise in oil prices appears to reflect, in the near term, unseasonably cold weather in several regions of the world and, in the longer term, higher projections of world demand, concerns about future oil supplies, and indications that OPEC may be raising its target price. We project the spot price of WTI, in line with future prices, to remain near current levels through most of this year and then to decline to just below \$50 per barrel by the end of 2006. These prices are around \$6 to \$7 per barrel higher than the prices in the January Greenbook. Our revision to the projected path of the price of imported oil is somewhat smaller than our revision for the WTI spot price—about \$3 per barrel higher on average in 2005 and about \$5 per barrel higher in 2006.

The starting value for our projected path of the broad real dollar is down about ½ percent relative to the assumption in the January Greenbook. We continue to project a gradual depreciation at an annual rate of about 1½ percent during the forecast period. Our projection for foreign real GDP growth is little changed at 3¼ percent in 2005 and 3½ percent in 2006.

Recent Developments and the Near-Term Outlook

Incoming spending data have been stronger than we anticipated in the January Greenbook. Business spending on equipment and software, especially, has been more resilient; indeed, the recent strength in this category appears most consistent with there having been little, if any, restraint from the expiration of the partial-expensing tax provisions on December 31. Growth in consumer spending and residential investment also looks to have remained strong in the current quarter. But imports appear to have increased substantially more than we had expected. On net, we now project that real GDP will increase 4¼ percent at an annual rate in the first quarter, up ½ percentage point from our January estimate. In the second quarter, we look for real GDP to rise at an annual rate of about 4 percent.

Real PCE is expected to rise at an annual rate near 4 percent in both the first and the second quarters of this year. Current-quarter spending is held down by a drop in motor vehicle sales in January and February, which likely stems from both lower incentives and some payback from the very high sales that occurred late last year. However, retail sales

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

Measure	2005:Q1		2005:Q2	
	Jan. GB	Mar. GB	Jan. GB	Mar. GB
Real GDP	**3.8**	**4.3**	**4.0**	**4.1**
Private domestic final purchases	2.8	4.2	4.7	4.8
Personal consumption expenditures	3.7	3.9	4.0	3.9
Residential investment	3.1	6.3	4.2	5.8
Business fixed investment	-3.2	4.8	10.0	10.4
Government outlays for consumption and investment	3.9	3.3	2.9	2.6
	Contribution to growth (percentage points)			
Inventory investment	.3	.7	-1.1	-1.1
Net exports	.4	-.6	.4	.6

excluding motor vehicles rose solidly in January and February, with widespread gains across expenditure categories.

Activity in housing markets has remained very strong, and we expect residential construction to post solid increases in the first half of this year. The pace of starts in the single-family sector surged at an annual rate of almost 1.78 million units, on average, in January and February; we expect starts to move back down to a pace of 1.62 million units in the second quarter—a rate that still exceeds the already robust 1.6 million units started last year. Multifamily starts also moved up somewhat in the first two months of the year.

The available indicators suggest that the growth of business investment in equipment and software slowed in the current quarter but not nearly so much as we had been expecting in light of the expiration of the partial-expensing tax provisions. We estimate that real outlays for E&S will increase at an annual rate of 5¼ percent this quarter—down from last year's 14¼ percent increase but well above the 5 percent rate of decline that we had anticipated in the January Greenbook. A good part of the slowing from last year's pace reflects a drop-back in motor vehicle expenditures following a sharp fourth-quarter increase. We estimate that, outside the transportation area, real spending will increase in the first quarter at an annual rate only a little less than last year's impressive increases.

Business spending for nonresidential structures, after remaining about flat in 2004, is expected to increase slowly in the first half of this year. We expect the drilling and mining sector to continue to expand rapidly in the first half in response to high prices for oil and natural gas. For structures outside drilling and mining, available indicators, though by no means strong, do suggest that markets are firming somewhat, and we look for spending to level off in the first half of this year after declining in 2004.

We project that real nonfarm inventory investment will contribute ¾ percentage point to GDP growth in the current quarter but will subtract 1 percentage point from growth in the second quarter. This swing reflects developments in the motor vehicles sector. Automakers have boosted assemblies in the first quarter even as sales have declined, and dealer stocks have risen notably from already elevated levels. However, manufacturers have reduced their second-quarter schedules substantially. Outside the motor vehicle sector, firms are expected to invest in inventories in the first half of the year at a rate about in line with the pace of final sales.

In the federal government sector, expenditures related to Iraq and Afghanistan are expected to boost defense spending further in the first half of this year. However, we look for real nondefense spending to rise only slowly. In total, we anticipate that real federal consumption and gross investment will rise at an annual rate of about 4½ percent in the first half of 2005, close to the pace of 2004. Fiscal conditions continue to improve in the state and local sector, and spending appears to be rising at a moderate pace. We are projecting real expenditures, which remained about flat last year, to rise at an annual rate of around 2 percent in both the first and second quarters of this year.

After their pronounced weakness in the fourth quarter, exports are projected to grow much more rapidly this quarter. At the same time, based on the strength of the January trade data, imports should post another sharp increase this quarter, though not quite so large as the fourth-quarter increase (which included a surge in oil imports associated with hurricane-related disruptions of domestic production in the Gulf of Mexico). In our forecast, these data combine to arithmetically subtract about ½ percentage point from the change in real GDP this quarter.

Labor demand appears to be gaining strength. Private payroll employment rose 229,000 in February, bringing the three-month average increase to 167,000. Consistent with the recent drop in initial claims for unemployment insurance to around the 315,000 mark, we project further solid gains in private payrolls in the coming months—200,000 per month in March and April and 225,000 per month in May and June. Given the projected pickup in employment, we anticipate that the unemployment rate will tick down to 5.3 percent in the second quarter.

Incoming data on compensation costs have been mixed. Based on information derived from the unemployment insurance tax records, compensation per hour in the nonfarm business sector was revised up in the third quarter of last year; over the second half of last year, nonfarm compensation per hour is now reported as having increased at an annual rate of about 4½ percent, about ½ percentage point above our earlier forecast. But the employment cost index rose considerably less than expected in the fourth quarter, with the softness concentrated in the wage and salary component; the overall ECI was up at a rate of only 3¼ percent over the second half of last year, about ½ percentage point below our earlier expectations. We project both compensation measures to increase at an annual rate of about 4¼ percent in the current quarter. Meanwhile, nonfarm productivity is projected to increase at an annual rate of 3½ percent in the first quarter, and unit labor costs are expected to increase only ¾ percent at an annual rate.

Some core inflation measures picked up early this year. The core PCE price index increased 0.3 percent in January after having risen 0.1 percent per month, on average, in the fourth quarter. The market-based core PCE price index also rose 0.3 percent in January. In addition, producer prices at earlier stages of processing moved up more than we had expected in January. In response to these higher-than-expected price increases, we have revised up our projection for core PCE price inflation to a little more than 2 percent in the first quarter—¾ percentage point more than our January Greenbook estimate. In the second quarter, we project core PCE prices to rise at a more modest annual rate of 1¾ percent. Overall consumer prices should post larger increases over the first half of the year as the recent run-up in oil prices shows through to prices of finished energy goods.

The Longer-Run Outlook for the Economy

We now project real GDP growth of 4 percent in 2005, the same projection as in 2004. Monetary policy will be less accommodative this year than last. Moreover, fiscal policy will provide less stimulus this year than in 2004, although the turnaround will be smaller than we thought in previous Greenbooks because we now believe that partial expensing provided little stimulus last year and is imposing little restraint this year. And the earlier sharp increases in equity and home prices should provide a smaller impetus to growth of consumer spending this year. However, the restraint from the external sector is projected

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

Measure	2005 H1	2005 H2	2006
Real GDP	**4.2**	**3.8**	**3.6**
Previous	3.9	3.8	3.6
Final sales	4.4	4.0	3.7
Previous	4.3	3.8	3.6
PCE	3.9	3.8	3.6
Previous	3.8	3.8	3.7
Residential investment	6.0	-.7	0.2
Previous	3.7	1.7	1.0
BFI	7.6	10.4	8.9
Previous	3.2	8.7	8.3
Government purchases	3.0	2.5	2.3
Previous	3.4	2.7	2.5
Exports	8.3	9.1	7.5
Previous	8.3	9.0	7.2
Imports	5.5	6.9	6.8
Previous	2.6	7.9	7.6
	Contribution to growth (percentage points)		
Inventory change	-.2	-.2	.0
Previous	-.4	.0	.1
Net exports	.0	-.2	-.3
Previous	.4	-.3	-.4

to lessen noticeably and, by the latter part of the year, the drag from energy prices should diminish considerably. In 2006, the further withdrawal of monetary policy accommodation, the waning effect of the wealth increases in 2003 and 2004, and a greater drain from further rapid increases in imports contribute to a projected slowing of GDP growth to about 3¾ percent.

Household spending. We project real PCE to rise at an annual rate of about 3¾ percent, on average, over both 2005 and 2006, about the same pace as during the preceding two years. Real disposable income is expected to rise considerably more rapidly over the forecast period than in recent years (abstracting from the Microsoft dividend payments) as a result of increases in employment; declines, albeit delayed, in energy prices; and next year's introduction of the Medicare drug benefit. Partially offsetting the influence of rapid before-tax income growth, however, are rising interest rates, a waning impetus from the earlier sharp run-ups in equity prices and real estate values, and diminished stimulus from the earlier cuts in personal tax rates. We expect the personal saving rate to move up over the next two years from around ½ percent in the first quarter to 2¼ percent in late 2006.

We anticipate that activity in the residential construction sector will remain strong over the next two years. Housing demand should be supported by continued favorable mortgage interest rates and rising real incomes. We are projecting that starts of new single-family homes will drop back from the recent extraordinary levels and then drift lower to 1.58 million units per year by 2006. At the same time, we expect multifamily starts after the near term to remain around the pace of 350,000 units per year that has prevailed for some time.

Business investment. As noted earlier, we revised up our projection for E&S spending in the first half of this year in response to incoming data suggesting that the partial-expensing tax incentives have had very little effect on business spending. Beyond the near term, our projection is similar to that in the January Greenbook, although new data have led us to revise up our estimate of the underlying trend for business purchases of motor vehicles—especially medium and heavy trucks. As in previous Greenbooks, investment growth should be promoted by steadily rising sales and the ongoing need of businesses to replace and upgrade equipment and software. In addition, financing costs should remain favorable overall, though the upward revision to our interest rate path has held down the projection somewhat. On net, we project E&S to increase at an annual rate of about 11½ percent in the second half of this year and to rise 10½ percent in 2006. We project spending on high-tech equipment to rise at its long-run average of 17 percent at an annual rate over this period and outlays for other types of equipment to rise at a solid rate of 6½ percent.

Beyond the near term, inventories are expected to play only a small role in the dynamics of aggregate output. Businesses rebuilt their inventory stocks substantially last year, and we view inventories, overall, as being roughly in line with sales at present. Inventory investment should continue in the period ahead at a rate consistent with a gradual decline in the ratio of stocks to sales that reflects businesses' ongoing improvements in inventory management. Thus, nonfarm inventory investment, which contributed about ½ percentage point to real GDP growth last year, is projected to have only a small negative influence on growth in 2005 and 2006.

Government spending. The path for government purchases is little changed in this projection. We expect real defense expenditures, after posting substantial increases in the first half of this year, to decelerate gradually and to rise about 2½ percent next year. Nondefense expenditures are expected to eke out meager increases both this year and next. At the state and local level, improved budgetary conditions should allow a moderate pickup in spending over the next two years. We project real state and local purchases, which rose just ½ percent in 2003 and 2004, to rise 2¼ percent this year and 2½ percent in 2006.

Net exports. After recovering in the current quarter from their surprisingly weak performance in the fourth quarter of last year, exports are projected to grow solidly, supported by the effects of past and prospective depreciation of the dollar and continued foreign growth. We project the growth of real exports of goods and services to be 8¾ percent during 2005 and to slow to 7½ percent in 2006, as the boost from the dollar's previous rapid decline wanes. Growth of imports is expected to moderate to 6¼ percent this year, partly because of some payback from the fourth-quarter surge in oil imports. Real imports are then projected to rise 6¾ percent in 2006. In all, real net exports are expected to be a roughly neutral influence on real GDP growth this year and to subtract about ¼ percentage point from growth in 2006. *(The International Developments section provides more detail on the outlook for the external sector.)*

Aggregate Supply, the Labor Market, and Inflation

In response to further upward surprises in labor productivity, we have revised up our estimate of structural productivity growth in this Greenbook. We now judge more of the increase in multifactor productivity in 2004 to have been structural rather than cyclical. We also nudged up our estimates of structural multifactor productivity growth in 2005 and 2006. In addition, the higher pace of fixed investment in this projection has boosted the contribution to productivity growth from capital deepening in these years. In all, structural productivity growth has been raised between ¼ percentage point and ½ percentage point per year from 2004 through 2006.

Decomposition of Potential GDP
(Percent change, Q4 to Q4, except as noted)

Measure	1974-95	1996-2001	2002	2003	2004	2005	2006
Potential GDP	**3.0**	**3.4**	**3.3**	**3.6**	**3.7**	**3.3**	**3.3**
Previous	3.0	3.4	3.4	3.8	3.4	3.2	3.2
Contributions[1]							
Structural labor productivity	1.5	2.7	3.3	3.7	3.4	2.9	3.0
Previous	1.5	2.7	3.2	3.7	3.0	2.7	2.7
Capital deepening	.7	1.3	.6	.7	.8	1.0	1.1
Previous	.7	1.3	.6	.6	.8	.9	.9
Multifactor productivity	.5	1.1	2.4	2.8	2.4	1.7	1.7
Previous	.5	1.1	2.4	2.8	2.0	1.6	1.5
Labor composition	.3	.3	.3	.3	.3	.3	.2
Potential labor input	1.7	1.0	1.0	.9	1.0	.8	.7
Previous	1.7	1.0	1.1	1.1	1.0	.9	.9
Technical factors	-.1	-.3	-.9	-1.0	-.6	-.4	-.4

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

1. Percentage points.

Besides making these changes to structural productivity, however, we have also reduced our estimates of the trend in potential labor input. We have reassessed the influence of past and prospective demographic trends on labor-force participation, and although we continue to believe that participation has been depressed to an unusual extent by cyclical factors, we now believe that a larger share of the recent weakness will prove to be persistent. In addition, we now judge the trend workweek to be a tad lower than previously assumed. In all, our new, lower estimate of potential labor input offsets most of the upward revision to structural productivity, leaving the level of potential GDP little changed at the end of 2004. Over the forecast period, our estimate of the growth of potential output still rounds to 3¼ percent per year.

With GDP rising faster than potential, we project that the output gap will be almost closed by the end of 2006. Likewise, the unemployment rate is projected to fall gradually, ending the forecast period just above our 5 percent estimate of the NAIRU. We have marked up our projection for core inflation a little, and higher energy prices hold up headline price inflation this year.

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

Measure	2003	2004	2005	2006
Output per hour, nonfarm business	5.5	2.9	2.3	2.5
Previous	5.6	2.8	1.7	2.2
Nonfarm private payroll employment	-.1	1.8	2.1	1.6
Previous	-.2	1.8	2.2	1.9
Household survey employment	1.2	1.3	1.4	1.5
Previous	1.2	1.3	1.8	1.5
Labor force participation rate[1]	66.1	66.0	66.0	66.1
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]	1.5	1.2	.5	.2
Previous	1.7	1.3	.6	.2

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.

Productivity and the labor market. As noted above, we expect private payrolls to expand about 200,000 to 225,000 per month in the second quarter, and we project this pace of net job gains to persist through the second half of the year. Job creation is then assumed to slow in 2006 as increases in production and sales moderate. This pace of job gains should be sufficient to bring the unemployment rate down to 5¼ percent at the end of this year and to just above 5 percent—our estimate of the NAIRU—at the end of 2006. We expect labor force participation to rise from its current level but to a notably lesser extent than in earlier Greenbooks in light of our downward revision to the trend in participation. Thus, we now project the participation rate to firm from 65.8 percent in February to 66 percent by June but only to edge higher to 66.1 percent next year.

We have raised our projection for actual productivity growth along with our estimates of structural productivity, but the basic contour of the forecast has not changed. We still believe that labor productivity stands somewhat above its structural level at present—we now put the gap at 1¼ percent at the end of 2004, ½ percentage point less than in the January Greenbook—and that the gap will close further as labor demand continues to strengthen. Thus, we project that productivity will increase less than its structural rate over the forecast period. Specifically, we look for increases in actual productivity of

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

Measure	2003	2004	2005	2006
PCE chain-weighted price index	1.7	2.6	1.9	1.4
Previous	1.7	2.5	1.3	1.3
Food and beverages	2.7	2.9	2.1	2.0
Previous	2.7	2.9	2.0	1.8
Energy	7.2	18.5	2.1	-2.0
Previous	7.2	17.8	-3.4	-1.2
Excluding food and energy	1.2	1.6	1.8	1.6
Previous	1.2	1.5	1.6	1.4
Consumer price index	1.9	3.4	2.1	1.7
Previous	1.9	3.4	1.5	1.6
Excluding food and energy	1.2	2.1	2.2	2.0
Previous	1.2	2.1	2.0	1.8
GDP chain-weighted price index	1.7	2.4	1.8	1.7
Previous	1.7	2.3	1.5	1.6
ECI for compensation of private industry workers[1]	4.0	3.8	4.4	4.5
Previous	4.0	4.0	4.3	4.2
NFB compensation per hour	5.3	4.2	4.3	4.6
Previous	5.4	4.0	4.2	4.2
Prices of core nonfuel imports	1.6	3.7	2.2	.5
Previous	1.6	3.8	1.2	.2

1. December to December.

2¼ percent this year and 2½ percent in 2006, compared with a structural rate of 3 percent over those two years.

Prices and labor costs. As described above, we have nudged up the forecast for core consumer price inflation in light of somewhat disappointing incoming data on core PCE inflation and the expected effects of higher energy costs and larger increases in import prices. These influences are only partly offset by the brighter outlook for structural productivity growth. The overall contour of the projection is similar to that of previous Greenbooks. Slack in labor and product markets should continue to hold down inflation, albeit to a smaller degree than in previous years; the influence of energy and import prices on business costs should wane given our assumptions about oil prices and the dollar; and a solid pace of structural productivity gains should provide firms with the ability to cushion the cost increases that do occur—including, most importantly, labor compensation. In all, we now project core PCE prices to rise 1.8 percent this year and 1.6 percent in 2006; both figures are 0.2 percentage point higher than in the January Greenbook. With the revised oil price path, we now expect finished energy prices to begin declining only in the latter part of 2005. As a result, our forecast for total PCE price inflation has been marked up more than ½ percentage point, to 1.9 percent this year—an increase still considerably lower than last year's 2.6 percent. In 2006, when energy prices are projected to be falling, we are forecasting total PCE price inflation to be 1.4 percent.

For hourly compensation, we project that both the employment cost index and compensation per hour in the nonfarm business sector will increase about 4½ percent per year over the forecast period. These increases are a little higher than in the last Greenbook as a result of higher projected overall price inflation. With higher structural productivity growth, however, structural unit labor costs are expected to rise a bit less than 1½ percent per year, on average—the same pace as in the January Greenbook.

Financial Flows and Conditions

After having increased 8½ percent last year, domestic nonfinancial debt is projected to expand 7½ percent this year and 7 percent in 2006. The projection calls for slower debt growth than last year for households, the federal government, and state and local governments, which more than offsets an expected increase in the rate of business borrowing.

Household debt growth, which totaled 11 percent last year, is expected to moderate to 8¼ percent this year and 7 percent next year. This decline reflects a projected slowdown in the pace of mortgage borrowing, which is damped by reduced home-price appreciation and a diminished volume of cash-out refinancing under our assumption that mortgage rates remain above their lows in recent years. In contrast, we expect consumer debt to expand a bit faster than last year's pace, as households rely less on home equity extraction to finance spending.

Buoyed by a turnaround in short-term borrowing, nonfinancial business debt grew 5¾ percent last year, and we expect growth to pick up to 6¾ percent this year and next. The projected acceleration of business debt mainly reflects anticipated financing of growing capital expenditures, with robust merger and acquisition activity and share repurchases providing some further impetus to borrowing. That said, the demand for external finance in the forecast is tempered by the unusually large stock of liquid assets that firms have accumulated over the past few years.

Federal debt, which grew 9 percent last year, is expected to increase at a pace of about 8½ percent through the end of 2006—a pattern that reflects the slight narrowing of the budget deficit after 2004 in our forecast. We expect the growth of state and local government debt to decline from the pace of 7½ percent registered last year to 4½ percent this year and 2¾ percent in 2006, as borrowing is held down by reduced opportunities for advance refundings at higher interest rates.

After expanding 5¼ percent in 2004, M2 is projected to increase only 3 percent this year and 4 percent during 2006. Money demand is anticipated to expand considerably less than nominal income over the forecast period primarily because of the rising opportunity costs associated with monetary policy tightening.

Alternative Simulations

In this section, we evaluate several risks to the staff forecast using simulations of the FRB/US model. The first three scenarios all involve a more-rapid-than-expected expansion in aggregate spending but differ in the implications for inflation. We then consider alternative assessments of the amount of slack remaining in the economy. The final scenario considers the effects of a sharp rise in bond yields. In all these simulations the federal funds rate is held at its baseline path.[1]

Spending boom. We have been surprised by the strength of the economy over the inter-meeting period, and we have marked up the near-term forecast accordingly. But we may have underestimated the signal from these incoming data for the underlying thrust of aggregate demand over the longer run. In this scenario, the personal saving rate remains around ¾ percent through late next year, rather than rising to 2¼ percent as in the baseline. E&S spending is also stronger than in the baseline, maintaining the robust pace of 2004 through this year and returning to the more moderate baseline pace only in 2006. As a result, real GDP increases about 4½ percent both this year and next, a pace sufficient to pull the unemployment rate down to 4¼ percent by the end of next year.

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[1] We do not include a market-based funds rate scenario because the baseline path for the funds rate is not materially different from the one implied by futures market quotes.

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

Measure and scenario	2004	2005		2006
	Q4	H1	H2	
Real GDP				
Baseline	**4.3**	**4.2**	**3.8**	**3.6**
Spending boom	4.3	4.5	4.6	4.6
With rising inflation expectations	4.3	4.5	4.6	4.9
Faster productivity growth	4.3	4.6	4.7	4.5
No room to grow	4.3	4.2	3.7	3.5
More room to grow	4.3	4.3	3.9	3.7
Higher bond premiums	4.3	4.1	3.0	2.6
Civilian unemployment rate[1]				
Baseline	**5.4**	**5.3**	**5.3**	**5.1**
Spending boom	5.4	5.3	5.1	4.3
With rising inflation expectations	5.4	5.3	5.1	4.2
Faster productivity growth	5.4	5.4	5.4	5.1
No room to grow	5.4	5.1	4.9	4.5
More room to grow	5.4	5.5	5.6	5.3
Higher bond premiums	5.4	5.3	5.5	5.8
PCE prices excluding food and energy				
Baseline	**1.6**	**1.9**	**1.7**	**1.6**
Spending boom	1.6	1.9	1.7	1.7
With rising inflation expectations	1.6	1.9	1.9	2.4
Faster productivity growth	1.6	1.8	1.3	1.1
No room to grow	1.6	1.9	1.9	1.9
More room to grow	1.6	1.9	1.5	1.3
Higher bond premiums	1.6	1.8	1.6	1.4

1. Average for the final quarter of the period.

However, because inflation expectations are assumed to remain well anchored, actual inflation is only a touch higher than the baseline projection.

Spending boom with rising inflation expectations. Of course, inflation expectations might not remain so well contained in the event of a spending boom, especially in the absence of a monetary policy response to that boom. This scenario incorporates the assumptions of the previous one and assumes further that the unchecked surge in real activity causes long-run inflation expectations to climb a full percentage point. The rise in expectations causes actual price increases to pick up markedly, and by 2006 core PCE inflation reaches 2½ percent. Higher actual and expected inflation reduces real interest rates, further stimulating real activity. As a result, real GDP growth climbs to 5 percent next year, and by late 2006 the unemployment rate falls below 4¼ percent.

Faster productivity growth. In the preceding two scenarios, aggregate demand grows at a faster pace than in the baseline essentially for autonomous reasons. But in this third scenario, we explore the alternative possibility that stronger demand reflects more-robust growth of aggregate supply. In this simulation, structural multifactor productivity continues to rise at its 2004 pace of nearly 2½ percent, rather than slowing to 1¾ percent as in the baseline. This change implies a more favorable long-run outlook for personal income and corporate earnings and, therefore, larger increases in household spending and business investment. However, bond and equity prices are little changed because the more rapid growth in potential output is assumed to have already been anticipated by the public. Under these conditions, real GDP grows about as rapidly as in the first scenario. However, because stronger demand is largely matched by stronger supply, the unemployment rate is little changed from baseline. Moreover, with structural unit labor costs rising at an average pace of less than ¾ percent over the projection period (compared wth 1½ percent in the baseline), core PCE inflation falls to just over 1 percent in 2006.

No room to grow. Given the inherent difficulty of measuring economic slack, there is a risk that the economy may already be operating at or beyond its potential. This scenario assumes that the NAIRU is currently 5½ percent—½ percentage point above the baseline estimate. The scenario also incorporates less scope for meeting future increases in the demand for workers through higher labor force participation; in particular, it assumes that the participation rate will fall steadily at about the average rate seen over the past five years, rather than rising as in the baseline. Because these less-favorable supply-side conditions imply lower levels of permanent income and corporate earnings, household and business spending is reduced somewhat, and real GDP grows a bit more slowly than in the baseline. However, because the flow of people into the labor force is marked down by more than the pace of hiring, the unemployment rate falls to 4½ percent by late 2006, exacerbating labor market pressures. This increased pressure, in turn, pushes up labor costs and causes core inflation to pick up to just under 2 percent.

More room to grow. In contrast to the previous scenario, the baseline may be underestimating the amount of slack in the economy. In this scenario, we assume that the true value of the NAIRU is 4½ percent. We also assume that trend labor force participation over the past few years has not been falling steadily (the current staff estimate) but instead has been following the higher trajectory incorporated into the January Greenbook. Accordingly, the actual participation rate in this scenario rebounds more sharply than in the baseline and follows a path similar to that projected at the time of the last FOMC meeting. The results are roughly symmetric to those of the previous scenario: Relative to baseline, real GDP grows slightly faster, the unemployment rate is higher, and core inflation is lower.

Higher bond premiums. We expect bond yields to be little changed over the remainder of this year and next as the effects of a rising funds rate are offset by revisions in the market's longer-run expectations for inflation. However, this forecast of bond yields entails some upside risks. First, our assumption that market participants 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 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. Additionally, if long-term rates were to rise and weaken real economic activity, risk premiums for corporate bonds over Treasuries might increase in response. These risks are realized in this scenario. The yield on ten-year Treasuries is 60 basis points higher than baseline in 2006, and yields on Baa corporate bonds are more than 80 basis points higher by late next year. The higher interest rates restrain consumption and investment, reducing real GDP growth ¾ percentage point on average this year and next. As a result, the unemployment rate rises to 5¾ percent by late 2006, and core inflation falls below 1½ percent next year.

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

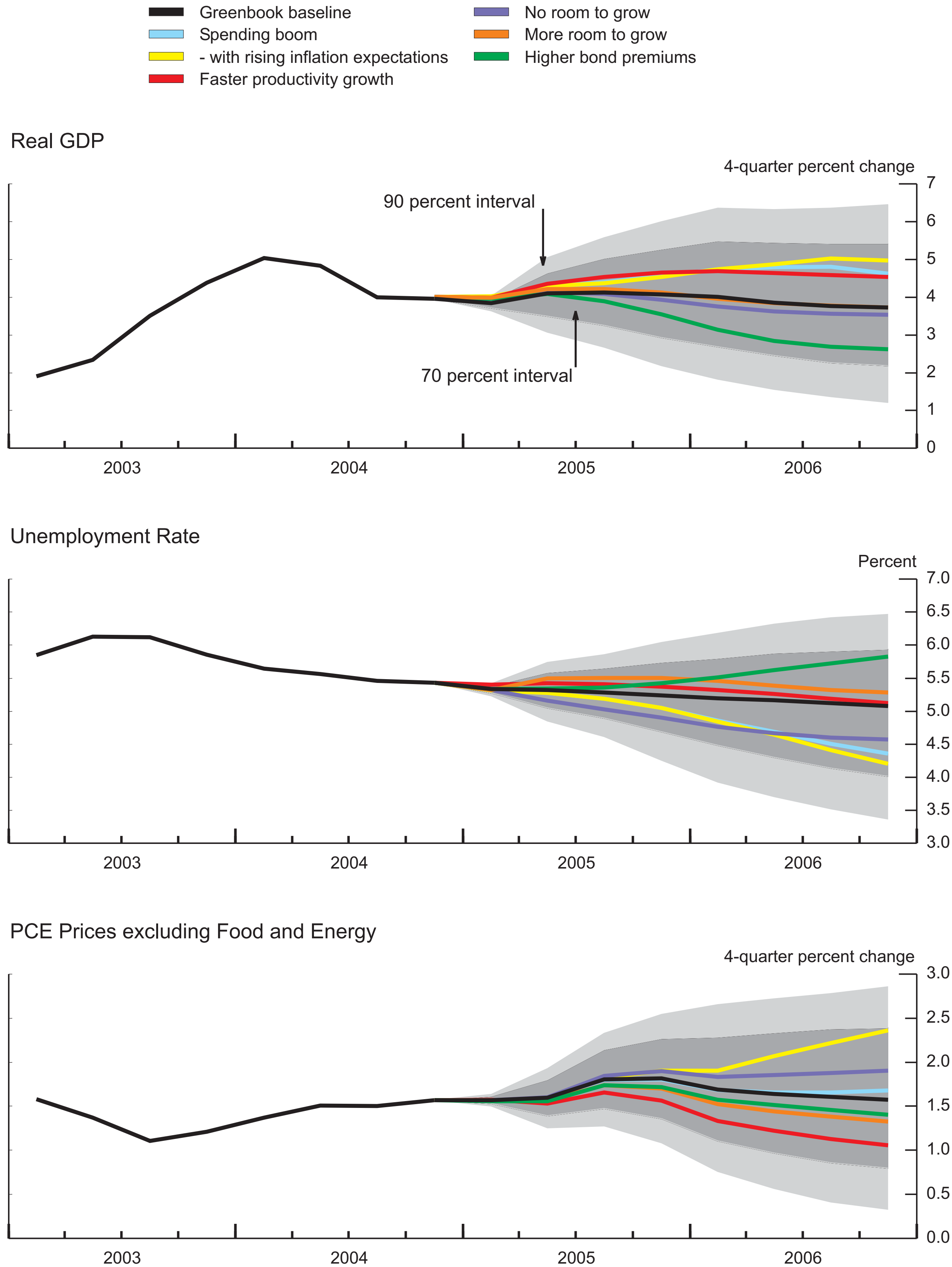
Measure	2005	2006
Real GDP		
(percent change, Q4 to Q4)		
Projection	4.0	3.6
Confidence interval		
Greenbook forecast errors[1]	2.4–5.6	1.9–5.3
FRB/US stochastic simulations	2.8–5.2	2.0–5.4
Civilian unemployment rate		
(percent, Q4)		
Projection	5.3	5.1
Confidence interval		
Greenbook forecast errors[1]	4.7–5.8	4.2–6.0
FRB/US stochastic simulations	4.7–5.8	4.1–6.0
PCE prices		
excluding food and energy		
(percent change, Q4 to Q4)		
Projection	1.8	1.6
Confidence interval		
Greenbook forecast errors[2]	1.3–2.4	0.6–2.5
FRB/US stochastic simulations	1.3–2.3	0.8–2.4

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



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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]	
		01/26/05	03/16/05	01/26/05	03/16/05	01/26/05	03/16/05	01/26/05	03/16/05	01/26/05	03/16/05
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	6.7	4.4	4.5	2.1	2.2	2.7	2.7	5.5	5.5
2005		5.5	6.2	3.8	4.1	1.6	2.1	2.1	2.6	5.3	5.3
2006		5.4	5.4	3.7	3.7	1.6	1.6	1.6	1.7	5.2	5.2
QUARTERLY											
2003	Q1	4.9	4.9	1.9	1.9	2.7	2.7	3.8	4.0	5.8	5.8
	Q2	5.3	5.3	4.1	4.1	1.1	1.1	0.7	0.4	6.1	6.1
	Q3	8.8	8.8	7.4	7.4	1.4	1.4	2.4	2.2	6.1	6.1
	Q4	5.7	5.7	4.2	4.2	1.6	1.6	0.7	0.9	5.9	5.9
2004	Q1	7.4	7.4	4.5	4.5	2.8	2.8	3.5	4.0	5.6	5.6
	Q2	6.6	6.6	3.3	3.3	3.2	3.2	4.8	4.4	5.6	5.6
	Q3	5.5	5.5	4.0	4.0	1.4	1.4	1.9	1.7	5.5	5.5
	Q4	5.4	6.6	3.5	4.3	1.9	2.2	3.4	3.4	5.4	5.4
2005	Q1	5.1	7.2	3.8	4.3	1.3	2.8	1.0	2.2	5.4	5.3
	Q2	5.6	6.0	4.0	4.1	1.6	1.8	1.8	3.4	5.3	5.3
	Q3	5.6	5.2	3.9	3.9	1.6	1.2	1.7	1.4	5.3	5.3
	Q4	5.4	5.2	3.8	3.8	1.5	1.4	1.6	1.5	5.3	5.3
2006	Q1	5.7	5.6	3.7	3.7	1.9	1.9	1.6	1.6	5.3	5.2
	Q2	5.2	5.3	3.6	3.6	1.6	1.6	1.6	1.7	5.2	5.2
	Q3	5.1	5.3	3.6	3.6	1.5	1.6	1.6	1.7	5.2	5.2
	Q4	5.1	5.2	3.6	3.6	1.4	1.5	1.6	1.7	5.1	5.1
TWO-QUARTER[3]											
2003	Q2	5.1	5.1	3.0	3.0	1.9	1.9	2.2	2.3	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	6.0	3.7	4.1	1.6	1.8	2.6	2.6	-0.2	-0.2
2005	Q2	5.3	6.6	3.9	4.2	1.4	2.3	1.4	2.8	-0.1	-0.1
	Q4	5.5	5.2	3.8	3.8	1.6	1.3	1.6	1.4	0.0	0.0
2006	Q2	5.4	5.5	3.6	3.6	1.7	1.8	1.6	1.6	-0.1	-0.1
	Q4	5.1	5.3	3.6	3.6	1.5	1.6	1.6	1.7	-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	0.4	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	6.5	3.8	4.0	2.3	2.4	3.4	3.4	-0.5	-0.5
2005	Q4	5.4	5.9	3.9	4.0	1.5	1.8	1.5	2.1	-0.1	-0.2
2006	Q4	5.3	5.4	3.6	3.6	1.6	1.7	1.6	1.7	-0.1	-0.1

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

Strictly Confidential <FR>
Class II FOMC

March 16, 2005

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

Item	Units[1]	1998	1999	2000	2001	2002	2003	2004	2005	2006
								- - - - - Projected	- - - - -	
Expenditures										
Nominal GDP	Bill. $	8747.0	9268.4	9817.0	10128.0	10487.0	11004.0	11737.3	12467.6	13137.5
Real GDP	Bill. Ch. $	9066.9	9470.3	9817.0	9890.7	10074.8	10381.3	10844.5	11285.0	11704.9
Real GDP	% change	4.5	4.7	2.2	0.2	2.3	4.4	4.0	4.0	3.6
Gross domestic purchases		5.5	5.5	3.0	0.4	3.1	4.3	4.6	3.9	3.7
Final sales		4.8	4.2	2.9	1.5	1.2	4.5	3.6	4.2	3.7
Priv. dom. final purchases		6.4	5.3	4.3	1.0	1.7	4.9	4.7	4.4	4.1
Personal cons. expenditures		5.4	4.9	4.1	2.8	2.5	3.8	3.7	3.8	3.6
Durables		14.4	7.3	4.7	10.8	1.5	9.9	5.4	4.9	6.0
Nondurables		4.7	4.9	3.0	1.9	2.3	4.6	4.4	5.1	4.3
Services		3.8	4.4	4.5	1.6	2.9	2.2	3.1	3.0	2.8
Business fixed investment		10.9	7.7	7.8	-9.6	-6.0	9.4	10.8	9.0	8.9
Equipment & Software		13.5	10.8	7.5	-9.0	-2.2	12.1	14.3	10.1	10.4
Nonres. structures		4.0	-0.9	8.8	-11.1	-16.1	1.5	-0.3	5.3	4.1
Residential structures		10.3	3.6	-1.9	1.4	6.9	12.0	6.5	2.6	0.2
Exports		2.6	5.6	6.5	-11.9	3.5	6.1	6.0	8.7	7.5
Imports		11.0	12.1	11.2	-7.6	9.7	4.9	9.6	6.2	6.8
Gov't. cons. & investment		3.3	4.2	0.4	5.0	3.8	2.2	1.7	2.7	2.3
Federal		0.1	4.2	-2.2	6.4	8.2	5.5	4.1	3.6	1.9
Defense		-1.2	4.3	-3.5	6.5	8.5	8.5	5.5	5.0	2.4
State & local		5.1	4.2	1.7	4.2	1.6	0.4	0.3	2.2	2.5
Change in bus. inventories	Bill. Ch. $	72.6	68.9	56.5	-31.7	11.7	-0.7	48.0	47.0	32.3
Nonfarm		71.2	71.5	57.8	-31.8	13.5	-1.1	44.7	44.7	30.3
Net exports		-203.8	-296.2	-379.5	-399.1	-472.1	-518.5	-583.2	-626.6	-647.7
Nominal GDP	% change	5.7	6.3	4.6	2.7	3.8	6.2	6.5	5.9	5.4
GDP Gap[2]	%	-1.5	-2.3	-2.4	0.2	1.6	2.0	1.3	0.7	0.3
Employment and Production										
Nonfarm payroll employment	Millions	125.9	129.0	131.8	131.8	130.3	130.0	131.5	133.9	136.3
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	4.3	5.0	4.2
Capacity util. rate - mfg.	%	81.8	81.1	80.6	74.5	73.5	73.7	76.7	79.2	81.2
Housing starts	Millions	1.62	1.64	1.57	1.60	1.70	1.85	1.95	2.01	1.93
Light motor vehicle sales		15.56	16.91	17.35	17.13	16.76	16.64	16.83	16.88	17.41
North Amer. produced		13.52	14.41	14.48	14.05	13.47	13.33	13.44	13.42	13.94
Other		2.04	2.50	2.87	3.08	3.29	3.31	3.39	3.46	3.47
Income and Saving										
Nominal GNP	Bill. $	8768.3	9302.2	9855.9	10171.6	10514.1	11059.2	11777.1	12474.1	13104.0
Nominal GNP	% change	5.5	6.5	4.7	2.9	3.5	6.5	5.8	5.7	5.0
Nominal personal income		7.0	5.5	7.1	2.2	1.9	4.6	6.6	5.6	6.5
Real disposable income		5.6	2.8	4.4	1.2	2.9	3.9	4.0	3.3	4.8
Personal saving rate	%	4.3	2.4	2.3	1.8	2.0	1.4	1.2	0.7	1.9
Corp. profits, IVA & CCAdj.	% change	-10.0	9.6	-8.6	-0.2	15.4	23.3	8.5	5.1	-0.2
Profit share of GNP	%	9.1	9.2	8.3	7.5	8.3	9.2	9.9	10.4	9.8
Excluding FR Banks		8.9	8.9	8.0	7.3	8.1	9.1	9.8	10.2	9.6
Federal surpl./deficit	Bill. $	38.8	103.6	189.5	46.7	-254.5	-364.5	-380.2	-315.0	-362.2
State & local surpl./def.		52.0	50.4	50.0	4.8	-25.0	-3.2	14.3	13.4	19.3
Ex. social ins. funds		50.3	48.7	47.9	2.2	-26.6	-4.3	12.9	11.9	17.8
Gross natl. saving rate	%	18.2	18.0	18.0	16.3	14.1	13.5	13.6	13.6	13.9
Net natl. saving rate		7.4	6.9	6.7	4.2	2.0	1.4	1.9	2.4	2.6
Prices and Costs										
GDP chn.-wt. price index	% change	1.1	1.6	2.2	2.4	1.6	1.7	2.4	1.8	1.7
Gross Domestic Purchases chn.-wt. price index		0.7	2.0	2.4	1.6	1.8	1.8	2.9	2.0	1.5
PCE chn.-wt. price index		0.9	2.1	2.3	1.7	1.8	1.7	2.6	1.9	1.4
Ex. food and energy		1.4	1.6	1.5	2.2	1.5	1.2	1.6	1.8	1.6
CPI		1.5	2.6	3.4	1.8	2.2	1.9	3.4	2.1	1.7
Ex. food and energy		2.3	2.0	2.6	2.7	2.1	1.2	2.1	2.2	2.0
ECI, hourly compensation[3]		3.5	3.4	4.4	4.2	3.2	4.0	3.8	4.4	4.5
Nonfarm business sector										
Output per hour		2.7	3.4	2.1	3.3	3.5	5.5	2.9	2.3	2.5
Compensation per Hour		5.5	5.2	6.4	3.6	2.9	5.3	4.2	4.3	4.6
Unit labor cost		2.7	1.7	4.3	0.3	-0.6	-0.2	1.1	1.9	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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March 16, 2005

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]	%	1.1	1.4	1.6	2.2	2.6	2.5	1.6	1.5	1.3	1.4
Employment and Production											
Nonfarm payroll employment	Millions	130.5	130.3	130.3	130.3	130.1	129.8	129.9	130.2	130.5	131.3
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		16.58	16.51	17.38	16.57	16.09	16.39	17.24	16.82	16.51	16.54
North Amer. produced		13.26	13.29	14.06	13.28	12.72	13.11	13.90	13.58	13.26	13.15
Other		3.32	3.22	3.32	3.29	3.37	3.28	3.34	3.24	3.26	3.39
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		1.6	3.2	2.0	2.2	4.0	0.4	2.2	0.9	4.0	4.4
Ex. food and energy		2.4	2.1	2.1	1.7	1.3	0.8	1.7	1.0	1.9	2.5
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	1.3	4.3	1.5	4.0	6.7	8.7	2.8	3.8	3.9
Compensation per hour		5.4	3.7	1.2	1.2	5.6	5.7	5.7	4.1	2.1	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.

Strictly Confidential <FR> March 16, 2005
Class II FOMC

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	12004.1	12215.7	12393.8	12550.7	12710.3	12884.4	13052.6	13221.5	13391.4
Real GDP	Bill. Ch. $	10891.0	11005.0	11121.4	11233.0	11340.0	11445.7	11549.0	11652.0	11756.5	11862.1
Real GDP	% change	4.0	4.3	4.3	4.1	3.9	3.8	3.7	3.6	3.6	3.6
Gross domestic purchases		3.9	5.3	4.8	3.3	3.6	3.9	4.0	3.2	3.7	4.0
Final sales		5.0	3.4	3.6	5.3	4.4	3.6	3.4	4.2	3.7	3.4
Priv. dom. final purchases		5.8	5.3	4.2	4.8	4.5	4.1	4.1	4.0	4.1	4.0
Personal cons. expenditures		5.1	4.2	3.9	3.9	3.9	3.7	3.7	3.6	3.6	3.6
Durables		17.2	3.2	-1.0	6.6	8.6	5.7	6.9	5.6	5.8	5.8
Nondurables		4.7	6.2	7.6	3.7	4.6	4.6	4.4	4.2	4.2	4.3
Services		3.0	3.4	3.1	3.5	2.6	2.8	2.7	2.9	2.8	2.8
Business fixed investment		13.0	13.8	4.8	10.4	11.3	9.6	9.7	9.0	9.1	8.0
Equipment & Software		17.5	17.8	5.2	12.4	12.7	10.2	11.2	10.4	10.6	9.2
Nonres. structures		-1.1	1.2	3.4	3.9	6.5	7.4	4.6	4.4	3.9	3.6
Residential structures		1.6	3.6	6.3	5.8	-0.3	-1.1	-0.9	-0.0	0.5	1.4
Exports		6.0	3.3	7.9	8.8	8.5	9.8	6.5	7.6	7.4	8.5
Imports		4.6	10.9	9.3	1.9	5.3	8.5	7.7	3.5	6.8	9.3
Gov't. cons. & investment		0.7	1.2	3.3	2.6	2.6	2.4	2.2	2.3	2.2	2.4
Federal		4.8	1.7	5.6	3.3	3.1	2.4	1.7	1.9	1.8	2.1
Defense		10.1	-0.3	8.0	4.3	4.1	3.6	2.1	2.4	2.3	2.8
State & local		-1.7	0.8	2.0	2.2	2.2	2.4	2.5	2.5	2.5	2.6
Change in bus. inventories	Bill. Ch. $	34.5	56.4	75.7	45.1	31.4	35.9	42.1	26.6	26.0	34.5
Nonfarm		30.4	55.2	73.2	42.1	29.5	34.0	40.2	24.5	23.9	32.5
Net exports		-583.2	-619.0	-636.8	-620.5	-619.9	-629.1	-644.4	-637.4	-646.1	-662.8
Nominal GDP	% change	5.5	6.6	7.2	6.0	5.2	5.2	5.6	5.3	5.3	5.2
GDP Gap[1]	%	1.3	1.2	1.0	0.8	0.6	0.5	0.4	0.4	0.3	0.2
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	131.7	132.3	132.8	133.5	134.2	134.9	135.5	136.1	136.6	137.0
Unemployment rate	%	5.5	5.4	5.3	5.3	5.3	5.3	5.2	5.2	5.2	5.1
Industrial prod. index	% change	2.7	4.4	4.5	4.4	6.1	5.1	4.5	4.3	4.1	3.9
Capacity util. rate - mfg.	%	77.0	77.6	78.4	78.7	79.5	80.2	80.7	81.0	81.4	81.6
Housing starts	Millions	1.97	1.98	2.15	1.99	1.96	1.95	1.94	1.93	1.93	1.93
Light motor vehicle sales		17.07	17.20	16.31	16.83	17.19	17.20	17.36	17.38	17.43	17.47
North Amer. produced		13.81	13.56	12.96	13.27	13.73	13.73	13.89	13.91	13.96	14.00
Other		3.27	3.65	3.35	3.56	3.46	3.47	3.47	3.47	3.47	3.47
INCOME AND SAVING											
Nominal GNP	Bill. $	11853.0	12015.7	12233.0	12404.3	12554.8	12704.5	12864.5	13024.1	13185.3	13342.1
Nominal GNP	% change	5.6	5.6	7.4	5.7	4.9	4.9	5.1	5.1	5.0	4.8
Nominal personal income		4.6	10.5	3.3	6.2	6.5	6.4	7.7	6.2	6.1	5.9
Real disposable income		2.9	8.0	0.3	3.1	4.8	4.9	6.0	4.5	4.5	4.2
Personal saving rate	%	0.7	1.5	0.6	0.5	0.7	1.0	1.6	1.8	2.0	2.2
Corp. profits, IVA & CCAdj.	% change	-17.7	44.2	20.9	8.3	-2.6	-4.5	-1.9	-0.3	1.7	-0.3
Profit share of GNP	%	9.4	10.2	10.5	10.6	10.4	10.1	10.0	9.8	9.7	9.6
Excluding FR Banks		9.3	10.0	10.3	10.4	10.2	10.0	9.8	9.7	9.6	9.5
Federal surpl./deficit	Bill. $	-375.0	-374.8	-318.7	-310.9	-313.0	-317.6	-370.8	-360.3	-360.4	-357.3
State & local surpl./def.		4.5	22.4	6.9	14.9	15.4	16.2	18.3	18.4	18.9	21.6
Ex. social ins. funds		3.0	21.0	5.4	13.4	13.9	14.7	16.8	16.9	17.4	20.1
Gross natl. saving rate	%	13.8	13.3	13.5	13.6	13.7	13.7	13.7	13.8	13.9	14.0
Net natl. saving rate		1.3	2.0	2.2	2.3	2.4	2.5	2.4	2.6	2.7	2.8
PRICES AND COSTS											
GDP chn.-wt. price index	% change	1.4	2.2	2.8	1.8	1.2	1.4	1.9	1.6	1.6	1.5
Gross Domestic Purchases chn.-wt. price index		1.9	2.8	2.5	2.6	1.3	1.4	1.7	1.4	1.4	1.4
PCE chn.-wt. price index		1.3	2.6	2.1	2.8	1.2	1.3	1.4	1.4	1.4	1.5
Ex. food and energy		0.9	1.6	2.1	1.8	1.7	1.7	1.6	1.6	1.6	1.5
CPI		1.7	3.4	2.2	3.4	1.4	1.5	1.6	1.7	1.7	1.7
Ex. food and energy		1.8	2.3	2.2	2.2	2.1	2.1	2.0	2.0	2.0	1.9
ECI, hourly compensation[2]		3.5	3.0	4.3	4.3	4.4	4.4	4.4	4.5	4.5	4.5
Nonfarm business sector											
Output per hour		1.3	2.8	3.5	2.1	1.8	1.8	2.0	2.5	2.7	2.7
Compensation per hour		5.4	3.4	4.2	4.2	4.3	4.4	4.5	4.5	4.6	4.6
Unit labor cost		4.0	0.6	0.7	2.0	2.5	2.6	2.4	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.

Strictly Confidential <FR>
Class II FOMC

March 16, 2005

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	4.0
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	4.8
Final sales	2.0	0.7	2.4	5.1	6.8	3.7	3.3	2.5	5.0	1.2	4.5	3.6
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	4.1
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	2.6
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	1.3
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	1.1
Equipment & Software	0.3	-0.2	0.3	0.8	1.5	0.9	0.6	1.1	1.3	-0.2	0.9	1.1
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	-0.8
Exports	0.3	-0.4	-0.2	-0.2	1.0	1.6	0.7	0.7	0.6	0.3	0.6	0.6
Imports	-0.7	-1.3	0.3	-0.3	-0.4	-2.2	-1.5	-1.8	-0.7	-1.3	-0.7	-1.4
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	0.3
Federal	0.2	0.6	0.0	1.4	-0.2	0.3	0.5	0.2	0.3	0.5	0.4	0.3
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	0.0
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	0.5
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.

Strictly Confidential <FR>
Class II FOMC

March 16, 2005

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	4.3	4.3	4.1	3.9	3.8	3.7	3.6	3.6	3.6	4.0	4.0	3.6
Gross dom. purchases	5.6	5.1	3.5	3.9	4.1	4.2	3.4	3.9	4.2	4.8	4.1	3.9
Final sales	3.5	3.6	5.2	4.3	3.6	3.4	4.2	3.7	3.4	3.6	4.2	3.6
Priv. dom. final purchases	4.5	3.6	4.1	3.9	3.5	3.6	3.5	3.5	3.5	4.1	3.8	3.5
Personal cons. expenditures	2.9	2.7	2.7	2.7	2.6	2.6	2.5	2.5	2.5	2.6	2.7	2.5
Durables	0.3	-0.1	0.5	0.7	0.5	0.6	0.5	0.5	0.5	0.5	0.4	0.5
Nondurables	1.2	1.5	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	0.9
Services	1.4	1.3	1.4	1.1	1.2	1.1	1.2	1.2	1.2	1.3	1.2	1.2
Business fixed investment	1.4	0.5	1.1	1.2	1.0	1.0	1.0	1.0	0.9	1.1	1.0	1.0
Equipment & Software	1.4	0.4	1.0	1.0	0.8	0.9	0.9	0.9	0.8	1.1	0.8	0.9
Nonres. structures	0.0	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.1	-0.0	0.1	0.1
Residential structures	0.2	0.4	0.3	-0.0	-0.1	-0.0	0.0	0.0	0.1	0.4	0.2	0.0
Net exports	-1.3	-0.6	0.6	0.0	-0.3	-0.5	0.2	-0.3	-0.6	-0.8	-0.1	-0.3
Exports	0.3	0.8	0.9	0.9	1.0	0.7	0.8	0.8	0.9	0.6	0.9	0.8
Imports	-1.6	-1.4	-0.3	-0.8	-1.3	-1.2	-0.6	-1.1	-1.5	-1.4	-1.0	-1.1
Government cons. & invest.	0.2	0.6	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.3	0.5	0.4
Federal	0.1	0.4	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.3	0.2	0.1
Defense	-0.0	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	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0	0.3	0.3
Change in bus. inventories	0.8	0.7	-1.1	-0.5	0.2	0.2	-0.5	-0.0	0.3	0.4	-0.2	-0.0
Nonfarm	0.9	0.6	-1.1	-0.4	0.2	0.2	-0.5	-0.0	0.3	0.5	-0.2	-0.0
Farm	-0.1	0.1	-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.

Strictly Confidential (FR)
Class II FOMC

March 16, 2005

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	2075	2213	410	550	479	487	438	629	520	520	469	674	550	535
Outlays[1]	2159	2293	2453	2593	581	576	565	605	624	609	614	636	669	649	640	664
Surplus/deficit[1]	-377	-413	-378	-380	-171	-26	-86	-118	-186	20	-94	-115	-200	25	-90	-129
On-budget	-538	-568	-540	-561	-194	-99	-96	-171	-207	-56	-106	-158	-239	-59	-104	-176
Off-budget	161	155	163	181	23	73	10	53	21	76	12	43	39	84	15	47
Means of financing																
Borrowing	374	378	379	387	136	41	83	102	155	19	104	100	185	4	98	119
Cash decrease	26	-1	1	-0	12	-23	8	12	12	-32	9	10	15	-25	0	10
Other[2]	-22	36	-3	-7	23	8	-6	4	18	-7	-19	5	0	-4	-8	-0
Cash operating balance, end of period	35	36	35	35	21	45	36	25	12	44	35	25	10	35	35	25
NIPA federal sector					Seasonally adjusted annual rates											
Receipts	1863	1933	2131	2276	1915	1949	1966	2015	2139	2172	2199	2225	2264	2293	2323	2353
Expenditures	2209	2314	2461	2628	2306	2329	2341	2390	2458	2483	2512	2543	2635	2653	2683	2710
Consumption expenditures	646	694	739	780	691	700	713	714	739	748	756	763	780	786	792	798
Defense	425	469	505	538	465	474	487	484	504	512	519	526	537	542	547	553
Nondefense	221	225	234	242	226	227	226	230	235	236	237	237	243	243	244	245
Other spending	1563	1620	1721	1849	1615	1629	1628	1676	1718	1735	1756	1780	1855	1868	1891	1912
Current account surplus	-345	-381	-329	-352	-391	-380	-375	-375	-319	-311	-313	-318	-371	-360	-360	-357
Gross investment	92	102	113	119	102	104	104	111	112	114	116	118	119	120	121	122
Gross saving less gross investment[3]	-347	-391	-346	-370	-402	-391	-386	-392	-335	-328	-331	-336	-389	-378	-378	-375
Fiscal indicators[4]																
High-employment (HEB) surplus/deficit	-274	-344	-317	-358	-359	-348	-343	-352	-303	-302	-310	-320	-376	-368	-370	-370
Change in HEB, percent of potential GDP	1.2	0.5	-0.4	0.2	0.2	-0.1	-0.1	0.0	-0.4	-0.0	0.0	0.0	0.4	-0.1	-0.0	-0.0
Fiscal impetus (FI) percent of GDP	0.9	0.8	0.4	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.0

1. CBO's March 2005 baseline surplus estimates are -\$412 billion in FY 2004, -\$365 billion in FY 2005 and -\$298 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)

March 16, 2005

			Nonfederal						
				Households					
Period [1]	Total	Federal government	Total	Total	Home mortgages	Consumer credit	Business	State and local governments	Memo: Nominal GDP
Year									
1999	6.4	-1.9	8.9	8.3	9.2	7.8	10.7	3.4	6.3
2000	4.8	-8.0	8.3	8.7	8.3	10.7	9.4	1.3	4.6
2001	6.2	-0.2	7.6	8.8	9.6	8.0	6.1	8.9	2.7
2002	6.8	7.6	6.7	9.6	11.8	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	8.6	9.0	8.5	11.0	13.3	4.9	5.7	7.4	6.5
2005	7.6	8.6	7.4	8.3	9.2	5.8	6.8	4.4	5.9
2006	6.9	8.5	6.5	6.9	7.5	5.4	6.8	2.8	5.4
Quarter									
2004:1	9.3	12.0	8.7	11.8	13.8	6.3	4.6	10.3	7.4
2	7.4	10.7	6.7	9.7	11.5	2.0	3.7	3.5	6.6
3	8.3	4.8	9.1	11.5	14.4	6.3	5.9	9.4	5.5
4	8.3	7.2	8.5	9.4	11.2	4.8	8.0	5.6	6.6
2005:1	9.2	12.7	8.4	9.0	10.2	6.0	7.5	9.1	7.2
2	7.2	7.9	7.0	8.2	9.2	5.4	6.3	3.1	6.0
3	6.6	6.2	6.7	7.7	8.4	5.8	6.3	2.7	5.2
4	6.5	6.5	6.5	7.1	7.7	5.5	6.5	2.6	5.2
2006:1	7.9	14.2	6.5	6.9	7.5	5.6	6.7	2.9	5.6
2	6.3	6.0	6.4	6.8	7.4	5.4	6.6	2.9	5.3
3	6.1	5.3	6.3	6.7	7.2	5.3	6.6	2.6	5.3
4	6.5	7.5	6.2	6.5	7.1	5.0	6.6	2.6	5.2

Note. Quarterly data are at seasonally adjusted annual rates.

1. Data after 2004:Q4 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)

March 16, 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	1604.0	1705.6	1649.6	1709.9	1721.0	1570.4	2029.5	1576.2	1490.4	1502.3	1956.9	1599.6	1583.5	1699.6
2 Net equity issuance	-57.8	-210.0	-183.0	-81.0	-203.2	-395.2	-192.0	-202.0	-181.0	-157.0	-103.0	-79.0	-71.0	-71.0
3 Net debt issuance	1661.7	1915.6	1832.6	1790.9	1924.2	1965.6	2221.5	1778.2	1671.4	1659.3	2059.9	1678.6	1654.5	1770.6
Borrowing sectors														
Nonfinancial business														
4 Financing gap [1]	-14.3	31.6	-7.3	119.5	-28.5	149.4	80.5	-56.3	-43.8	-9.7	21.7	132.6	147.9	176.0
5 Net equity issuance	-57.8	-210.0	-183.0	-81.0	-203.2	-395.2	-192.0	-202.0	-181.0	-157.0	-103.0	-79.0	-71.0	-71.0
6 Credit market borrowing	308.6	420.4	533.9	569.3	445.4	618.2	585.3	503.9	511.7	534.7	558.0	562.1	575.6	581.4
Households														
7 Net borrowing [2]	839.4	1017.9	847.0	767.4	1120.3	943.4	925.4	862.8	826.1	773.5	772.2	768.2	766.5	762.7
8 Home mortgages	733.6	884.9	692.7	616.8	1017.2	820.1	766.3	714.9	668.2	621.5	616.8	616.8	616.8	616.8
9 Consumer credit	88.4	101.3	125.0	123.7	132.7	101.3	128.2	118.4	129.3	123.9	127.8	124.7	123.0	119.2
10 Debt/DPI (percent) [3]	107.8	112.9	117.0	118.3	114.2	114.3	116.2	117.0	117.6	117.9	117.9	118.2	118.4	118.7
State and local governments														
11 Net borrowing	117.8	115.4	74.2	48.8	151.8	92.0	151.6	53.8	45.8	45.8	50.8	50.8	46.8	46.8
12 Current surplus [4]	176.2	192.7	176.3	188.1	198.4	180.4	167.7	177.1	179.1	181.4	184.9	186.5	188.5	192.6
Federal government														
13 Net borrowing	396.0	361.9	377.5	405.4	206.7	312.1	559.2	357.7	287.8	305.3	678.8	297.5	265.6	379.7
14 Net borrowing (n.s.a.)	396.0	361.9	377.5	405.4	83.3	102.1	154.7	18.9	103.6	100.4	184.6	3.8	98.0	119.0
15 Unified deficit (n.s.a.)	399.1	400.7	374.8	393.4	85.7	118.1	185.5	-20.0	94.0	115.2	200.0	-25.1	89.6	128.9
Depository institutions														
16 Funds supplied	476.4	824.0	612.0	582.9	424.1	1003.2	1130.5	386.9	460.1	470.3	677.7	515.2	609.1	529.5
Memo (percentage of GDP)														
17 Domestic nonfinancial debt [5]	194.4	197.8	201.3	204.8	198.4	199.4	200.2	201.4	202.3	203.0	203.9	204.8	205.4	206.0
18 Domestic nonfinancial borrowing	15.1	16.3	14.7	13.6	16.3	16.4	18.2	14.3	13.3	13.1	16.0	12.9	12.5	13.2
19 Federal government [6]	3.6	3.1	3.0	3.1	1.7	2.6	4.6	2.9	2.3	2.4	5.3	2.3	2.0	2.8
20 Nonfederal	11.5	13.2	11.7	10.5	14.5	13.8	13.6	11.5	11.0	10.7	10.7	10.6	10.5	10.4

Note. Data after 2004:Q4 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

Incoming data on fourth-quarter foreign economic activity suggest that growth continued at a moderate pace, with somewhat-slower-than-expected growth in the industrial countries and surprisingly strong performance in emerging markets. Going forward, indicators for the industrial economies are more positive, and we expect foreign growth to step up slightly over the remainder of the forecast period. Prices of oil and other commodities rose markedly over the intermeeting period, and they are projected to remain well above levels projected in the previous forecast. Foreign CPI inflation is estimated to have moved down in the current quarter because of transitory factors, but it is projected to average close to 2½ percent over the forecast period, mainly because of the higher paths for prices of energy and other commodities. Long-term interest rates rose on balance in both the United States and in the foreign industrial economies during the intermeeting period.

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

Indicator	2004		Projection				
	H1	Q3	2004: Q4	2005			2006
				Q1	Q2	H2	
Foreign output	4.1	2.7	3.1	3.0	3.3	3.4	3.4
January GB	*4.1*	*2.6*	*3.1*	*3.0*	*3.3*	*3.4*	*3.3*
Foreign CPI	2.9	3.0	2.1	1.1	2.5	2.3	2.3
January GB	*2.9*	*2.9*	*2.3*	*1.7*	*2.2*	*2.2*	*2.2*

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

The spot price of West Texas intermediate (WTI) crude oil rose about $8 per barrel over the intermeeting period, and the price of the NYMEX far-dated futures contract rose about $7 per barrel. Oil demand was boosted during the period by colder-than-average weather in key oil-consuming regions, and market participants have reportedly revised up their outlook for medium-term global oil demand. Prices of important non-energy commodities also rose sharply over the intermeeting period.

The dollar depreciated on balance over the intermeeting period on heightened market speculation that several major East Asian monetary authorities may further diversify their holdings of reserve assets and on ongoing investor concerns about the financing burden of the large and growing U.S. current account deficit. The projected value of the broad real dollar in the second quarter is ½ percent lower than in the previous Greenbook.

Going forward, the broad real dollar is projected to decline at an annual rate of about 1½ percent.

Since the January Greenbook, we have received U.S. trade data for December and revised data for November, which have led us to trim our estimate of the trade deficit and the negative contribution of net exports to real GDP growth in the fourth quarter. However, the January trade data point to considerably faster import growth and a larger trade deficit for the first quarter than we had anticipated earlier. Accordingly, net exports are now projected to subtract about ½ percentage point from GDP growth in the current quarter, whereas in the previous Greenbook the staff projected a positive contribution of almost ½ percentage point. On average for the rest of this year, net exports are projected to make a roughly neutral contribution to GDP growth, and in 2006 they subtract about ¼ percentage point as the effects of recent large declines of the dollar wane.

According to data that were published this morning, the U.S. current account deficit in the final quarter of last year stood at $751.6 billion (a.r.), or 6¼ percent as a share of GDP. These numbers are just a bit smaller than we estimated in this Greenbook. Although it was not possible to incorporate these data in this forecast, they suggest only small revisions to our projection that the current account deficit will reach about $900 billion, or 6¾ percent of GDP, by the end of 2006.

Oil Prices

The spot price of West Texas intermediate (WTI) crude oil closed at $55.05 per barrel on March 15, up sharply from the low of $40.70 per barrel set in mid-December. The increase in oil prices is due in large part to upwardly revised expectations of world oil demand. Recently, oil demand has been boosted by colder-than-normal weather in parts of the United States, Europe, and East Asia. Looking further ahead, both the U.S. Department of Energy and the International Energy Agency raised their projections for world oil demand in 2005 and lowered their projections for non-OPEC supply. In addition, earlier this year OPEC reduced oil production from its fourth-quarter level, and production growth in Russia slowed considerably. Also putting upward pressure on oil prices were hints by OPEC officials that a higher target price may be forthcoming. The Saudi oil minister stated that he expects oil prices to range between $40 and $50 per barrel throughout 2005. Today, OPEC increased its production target 500,000 barrels per day, saying that it expects particularly strong oil demand growth in the second half of this year. Oil prices changed little in response to this announcement, but rose in later intraday trading following the release of lower-than-expected U.S. oil inventories data. Concerns about future supply from Iraq, Iran, Nigeria, Venezuela, and Russia also continue to support spot and futures prices.

In line with futures prices, our projected path of oil prices over the forecast period is significantly higher than in the previous Greenbook. The spot price of WTI is projected to remain near $55 per barrel through midyear before edging down to $53.80 per barrel by the fourth quarter of 2005 and to $49.50 per barrel by the fourth quarter of 2006. Relative to the January Greenbook, this projection is about $6 per barrel higher on average in 2005 and about $6.80 per barrel higher in 2006. Our revision to the projected path of the price of imported oil is somewhat smaller. Relative to the January Greenbook, the price of imported oil is projected to be about $2.70 per barrel higher on average in 2005 and $5.20 per barrel higher in 2006, resulting in a nearly flat forecast path. The spread between the price of WTI and the average price of imported oil, which has been uncharacteristically wide and volatile the past few months, is difficult to predict and constitutes a risk to our forecast.

International Financial Markets

The trade-weighted exchange value of the dollar against the major foreign currencies declined 2¼ percent on balance over the intermeeting period. The dollar depreciated on net against all major foreign currencies with the exception of the yen, against which the dollar changed little. The dollar appreciated briefly in early February, reportedly in reaction to Chairman Greenspan's speech on the current account, which was interpreted by market participants as indicating diminished concern over the adjustment of the current account deficit. However, this move was subsequently more than unwound amid intensified market speculation that the monetary authorities of several East Asian economies may diversify their reserve holdings and as investors reacted to the large U.S. trade deficit for January. The dollar was unchanged on a trade-weighted basis over the period against the currencies of our other important trading partners. The Korean won and Taiwan dollar appreciated about 2¼ percent against the dollar despite unconfirmed intervention activity by the respective monetary authorities aimed at curbing the ongoing appreciation of their currencies.

Based on intermeeting developments, we have lowered the projected value of the broad real dollar in the second quarter ½ percent. We project that the broad real dollar will depreciate over the remainder of the forecast period at an annual rate of roughly 1½ percent, slightly faster than in the January Greenbook, mainly from revisions to projected relative inflation rates. This leaves the endpoint of the path of the broad real dollar almost 1 percent lower than we had projected in the January Greenbook. Our projection is predicated on the view that investor concerns about the financing burden of the large and growing U.S. current account deficit will continue. We do not include a change in China's exchange rate regime during the forecast period in our baseline projections, but such a change constitutes an obvious risk to our forecast. Some of the effects of a revaluation of the renminbi and other East Asian currencies against the dollar are explored in the alternative simulations described at the end of this document.

Three-month interest rates in the industrial countries were little changed on net, except for Australia and New Zealand, where the central banks tightened policy 25 basis points in response to signs of building inflationary pressures. Medium- and long-term nominal yields in the foreign industrial economies rose in response to mounting concerns over inflationary effects of the recent surge in oil and other primary commodity prices and as U.S. yields also rose. Government benchmark bond yields rose about 20 basis points in Europe, Canada, and Japan, compared to an increase of almost 40 basis points in the United States. Headline share price indexes rose 4 to 5 percent in Canada and Japan, outperforming comparable indexes in the euro area, the United Kingdom, and the United States. Sovereign yield spreads over Treasuries of several Latin American countries declined to new multiyear lows before rebounding late in the period, reportedly on concerns about the increases in nominal yields in the industrial economies. Brazilian share prices surged 13 percent on balance over the intermeeting period amid reports of strong private capital inflows. Nevertheless, the *real* depreciated 5 percent on balance against the dollar, as Brazil's central bank reportedly took measures to weaken the exchange value of its currency.

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

Foreign Industrial Countries

Fourth-quarter GDP growth in the foreign industrial countries edged down further, to less than 1½ percent at an annual rate. Net exports made a sizable negative contribution to growth in all the major industrial economies. Stronger data for the current quarter point to rebounding output in a few countries, especially in Japan, but high oil prices and domestic currency appreciation are likely to weigh on growth. We project that, as the effects of these factors abate, the average pace of expansion will edge up to around 2½ percent by the second half of this year and will continue near that pace over the remainder of the forecast period. Twelve-month headline inflation rates in the foreign industrial countries are projected to remain near 1½ percent over the forecast period.

Japanese output rose slightly in the fourth quarter, after contracting during the previous two quarters, but it appears to be strengthening more noticeably in the current quarter. January household expenditures soared, industrial production rose, and exports improved further. A recently passed supplementary budget will increase government spending in the near term. As a result, we forecast current-quarter output growth of roughly 1¾ percent at an annual rate and similar growth going forward as labor market conditions improve. Twelve-month CPI inflation is projected to turn positive on a sustained basis in 2006, and we have penciled in a slight rise in short-term market interest rates in the second half of that year, when, we assume, the Bank of Japan will begin its exit from quantitative easing.

Euro-area GDP growth weakened further in the fourth quarter, as the strong 3.1 percent rebound in France was insufficient to offset contractions in Germany, Italy, and the Netherlands. Recent data suggest that activity in France and Spain continues to expand briskly. Consumption growth in Germany should increase because its saving rate is not expected to continue to rise. We project that euro-area GDP will expand at a pace of around 1½ percent in 2005 and slightly faster in 2006, with a stronger outlook for France and Spain offsetting weaker forecasts for Germany and Italy. Headline and core inflation rates in the first two months of this year were unusually low, partly because of price declines for energy and larger-than-usual discounts on clothing and footwear. We expect twelve-month inflation to remain at or below 2 percent over the forecast period. Given this forecast of lower inflation and subdued growth, we now assume that the European Central Bank will not change its policy rates for the rest of the projection period, despite indications from the ECB that rates need to be raised to more-neutral levels.

Economic growth in the United Kingdom was a solid 2.9 percent in the fourth quarter and was marked by strong investment but decelerating consumption. Business confidence improved in January and February, and indicators in the manufacturing and services sectors, although down slightly, still point to expansion. We assume that increases in house prices will stabilize at low to moderate rates. Real GDP growth should remain around 2¾ percent over most of this year, before edging down to about 2½ percent in 2006 as fiscal policy becomes more contractionary. We now assume that the Bank of England's Monetary Policy Committee will raise rates another 50 basis points by early in

2006. This stance should be sufficient to prevent inflation from moving above the target rate of 2 percent.

Canadian GDP growth slowed to only 1.7 percent in the fourth quarter despite acceleration in domestic demand, as net exports provided a substantial negative contribution. Recent indicators show output growth picking up in the current quarter: The composite leading indicator improved in January, and employment rose on average over the first two months of this year. We project that the pace of output growth will climb to 3½ percent by late 2005, as the weakness in the external sector fades and the government's recent budget exerts a stimulative effect, and will settle down to about 3 percent by the end of the forecast period. We continue to 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 1¾ percent by late 2005, inflation is projected to creep back to the 2 percent midpoint of the Bank of Canada's inflation target range.

Other Countries

Real GDP growth in the emerging-market economies is estimated to have averaged a robust 5¾ percent in the fourth quarter of 2004, an estimate that is somewhat higher than the one shown in the January Greenbook, as activity picked up in Latin America and in emerging Asia. Data for the third quarter were revised up as well. We project aggregate growth to slow to about 4¾ percent this year and next, as China's growth returns to a more sustainable pace and monetary policy slows growth in Latin America.

Real GDP growth in emerging Asia is projected to dip a bit to about 5¼ percent at an annual rate over the forecast period, after averaging 5½ percent in the second half of last year. Chinese real GDP is expected to expand around 8 percent, down from more than 10 percent in the second half of 2004. This forecast assumes that China's investment growth will slow, bringing the investment share of GDP down from its recent unsustainably high level. There is some limited evidence that this slowing has begun.

Elsewhere in emerging Asia, although higher oil prices and a softening in high-tech demand damped activity in the second half of last year, the slowdown was not as pronounced as was estimated at the time of the last Greenbook. We therefore expect growth in these economies to remain at about its fourth-quarter pace of 4½ percent over the forecast period, as the restraining effects of higher oil prices are largely offset by some improvement in high-tech demand. The projected growth is widespread across the region, ranging from nearly 6 percent in the booming Indian economy to around

4 percent in South Korea, where consumption is expected to strengthen over the forecast period as consumer debt burdens slowly decline. We expect the reconstruction efforts in the countries affected by the tsunami to lead to a pickup in investment in 2005.

In Latin America, real GDP accelerated to an estimated rate of 5¼ percent in the fourth quarter, largely reflecting a rebound in Mexican growth. We continue to expect growth in this region to average about 4 percent both this year and next. The pace of expansion in Mexico is projected to slow from 5½ percent in the fourth quarter to about 4¼ percent over the forecast period, as continued tight monetary policy partly offsets the boosts from surging domestic demand, higher oil revenues, and solid expansion in the U.S. manufacturing sector. Interest rates are expected to remain high in Brazil, where growth is projected to average about 3 percent this year and next, down from nearly 5 percent last year.

Prices of Internationally Traded Goods

For the first quarter of 2005, core import prices are increasing at an estimated annual rate of 4½ percent, about the same pace as in the fourth quarter of 2004. As a result of stronger-than-expected BLS import price data for January and sharp increases in nonfuel commodity prices, our estimate of core import price inflation is a full percentage point higher than in the previous Greenbook forecast. In the monthly price data, increases were widespread across categories, with the price index for machinery showing an atypically large increase. These increases may reflect a lagged response by foreign exporters to earlier dollar weakness.

For the remainder of 2005, the rise of core import prices is expected to slow to about 2¼ percent (a.r.), lower than in the first quarter but higher than in the January Greenbook. The deceleration from the first quarter reflects a projected slowing of both dollar depreciation and primary commodity price inflation, in line with futures prices. In 2006, with only modest projected further declines in the dollar and with commodity prices having flattened, core import price inflation should move down to less than 1 percent. We have assumed that the recent expiration of the Multi-fiber Arrangement (MFA) will lead to an increase in the share of apparel imports from China and other low-cost producers and exert some downward pressure on overall core import prices during the next few years. However, this effect is projected to be small.

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	1.8	5.0	5.4	3.8	2.1	2.2
Imports							
Non-oil core goods	5.2	2.3	4.2	4.4	2.2	2.2	.6
Oil (dollars per barrel)	34.55	37.54	40.91	40.28	45.59	45.99	44.97

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.

In the first quarter of 2005, core export prices are projected to increase 5½ percent at an annual rate, following a 5 percent rise in the fourth quarter. The fourth-quarter price increase was a result mainly of higher prices for exported industrial supplies, particularly chemicals and fuels. The unexpectedly sharp increase in the BLS price data for January was also driven by the industrial supplies category, and for the first quarter, we have marked up our projection 3¼ percentage points relative to the January Greenbook. This upward revision is also supported by the higher domestic producer prices for intermediate goods. For the rest of 2005 and 2006, core export price inflation is projected to decline, as the high rates of inflation for intermediate goods and finished petroleum products abate.

Trade in Goods and Services

Nominal imports decreased less than expected in December, as a substantial decline in the value of oil imports was largely offset by a sharp increase in imports of non-oil goods. As a result, we now estimate that real imports increased a robust 11 percent in the fourth quarter, about 1½ percentage points above our estimate in the January Greenbook. The rise was concentrated in core goods and oil, whereas imports of services declined substantially.

In January, nominal imports jumped sharply on record purchases of consumer goods as well as strong imports of capital goods. For the current quarter we are projecting growth of overall real imports to edge down to a still-high rate of 9¼ percent. Imports of core goods grew more rapidly in the fourth quarter than was implied by U.S. GDP growth and relative prices and are poised to do so again in the current quarter. We expect services imports to rebound this quarter from their abnormally weak fourth quarter. In contrast, following a surge in the fourth quarter, real imports of oil are projected to flatten out as domestic oil production recovers from last year's hurricanes and domestic oil stocks are replenished more slowly.

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	3.3	7.9	8.8	9.1	7.5
January GB	*7.3*	*6.3*	*-.8*	*7.8*	*8.9*	*9.0*	*7.2*
Real imports	11.6	4.6	10.9	9.3	1.9	6.9	6.8
January GB	*11.6*	*4.6*	*9.4*	*2.4*	*2.9*	*7.9*	*7.6*

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

Our projection for first-quarter growth in real imports of goods and services is revised up considerably from the previous Greenbook, partly reflecting the effect of higher projected U.S. GDP growth on imports of core goods and services as well as the stronger-than-anticipated January data. Additionally, in previous Greenbooks we had assumed that the expiration of partial expensing tax provisions this year would lead to a temporary dip in imports of capital goods. However, a strong increase in capital goods imports in January has led us to reassess this assumption and to substantially moderate the projected dip in these imports.

For all of 2005, growth of imported real goods and services is expected to move down to 6¼ percent following growth of 9½ percent in 2004. This decline reflects primarily a moderation of core import growth from recent elevated levels to a pace that is more in line with U.S. income growth and relative prices, as well as the unwinding of the late-2004 surge in oil imports mentioned above. Conversely, the growth of imported services is projected to pick up this year, while the rate of expansion of imported high-tech products should be little changed. We expect growth of real imports to edge up to 6¾ percent in 2006, as the factors holding back oil imports in 2005 fade and the restraining effect of recent increases in import prices on imports of core goods and services diminishes.

Stronger-than-expected nominal exports in December, along with a large upward revision to the November data (attributable to the correction of faulty trade data from Canada), led us to raise our estimate of fourth-quarter real exports substantially from the January Greenbook. Even so, total real exports are estimated to have increased only 3¼ percent at an annual rate, with core goods exports growing only 1½ percent, well below what relative prices and foreign income growth would have suggested. As no special factors explain the fourth-quarter weakness, we are expecting some of those lost sales to be made up in the current quarter. Accordingly, and consistent with the January data, we are projecting first-quarter real export growth to recover to 8 percent, with core exports growing a bit faster than implied by foreign growth and stimulus from past declines in the dollar alone.

Real export growth is expected to increase to about 8¾ percent for 2005 as a whole, as exports of services, computers, and semiconductors recover from last year's weakness. Exports of core goods and of services are expected to be supported by continued foreign growth as well as the lagged effect of the previous decline in the dollar. We expect growth of exports of goods and services to fall back to 7½ percent in 2006, as the effect of past dollar depreciation on core goods and on services wanes, offsetting the effect of slightly higher projected foreign growth.

Alternative Simulations

Our baseline projection assumes that China keeps the value of its exchange rate fixed against the U.S. dollar. In our alternative scenario, we used the FRB/Global model to consider the effects of an immediate 20 percent revaluation of the renminbi against the dollar. We also consider a second scenario in which, in addition to the renminbi's revaluation, the other East Asian currencies (including the Japanese yen) appreciate 20 percent against the dollar. China is assumed to use capital controls so that it can keep its exchange rate fixed at the revalued rate and still use monetary policy to cushion the impact of the revaluation on aggregate demand.

The renminbi's revaluation by itself has a very small effect on the U.S. economy. U.S. real GDP rises 0.2 percentage point above baseline in 2005:H2 and 0.1 percentage point above baseline in 2006, largely because of the stimulus to real net exports. However, the stimulus is small because exports to China account for less than 5 percent of overall U.S.

exports and because import substitution away from Chinese products is limited by low pass-through of exchange rates to import prices. Accordingly, there is also a negligible impact of the renminbi's revaluation on the nominal trade balance.

Alternative Simulations:
The effects of a revaluation of the renminbi and other Asian currencies against the dollar
(Percent change from previous period, annual rate, unless stated otherwise)

Indicator and simulation	2005		2006	
	H1	H2	H1	H2
U.S. real GDP				
Baseline	4.2	3.8	3.6	3.6
I. RMB revaluation vs. dollar	4.2	4.0	3.7	3.7
II. Broad revaluation of East Asian currencies vs. dollar	4.2	4.2	4.1	4.0
U.S. PCE prices excluding food and energy				
Baseline	1.9	1.7	1.6	1.5
I. RMB revaluation vs. dollar	2.0	1.7	1.6	1.5
II. Broad revaluation of East Asian currencies vs. dollar	2.1	1.9	1.8	1.7
U.S. trade balance (Percent share of GDP)				
Baseline	-5.7	-5.7	-5.7	-5.6
I. RMB revaluation vs. dollar	-5.8	-5.7	-5.7	-5.6
II. Broad revaluation of East Asian currencies vs. dollar	-6.0	-5.9	-5.7	-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.

In the second scenario, we assume that the Chinese revaluation is accompanied by an immediate 20 percent appreciation of other developing Asian currencies and the Japanese yen against the dollar, which we model as a risk premium shock. In this case, U.S. real GDP growth rises ½ percentage point above baseline in 2005:H2 and in 2006. Core PCE inflation increases 0.2 percentage point above baseline in 2005:H1, largely because of higher import prices, and remains above baseline in 2006 because of cost pressures arising from increased resource utilization. The ratio of the trade balance to GDP deteriorates initially due to J-curve effects, as higher import prices boost nominal imports, but improves 0.1 percentage point in 2006:H2 relative to baseline as real imports fall and exports continue to rise. The small size of the improvement in the nominal trade balance partly reflects the fact that exports to these economies are only about 25 percent of total U.S. exports. Moreover, further improvement of the trade balance would take place beyond the two-year horizon of our simulation.

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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	3.4
Industrial Countries	2.7	4.4	3.5	0.8	2.6	1.7	2.2	2.3	2.6
of which:									
Canada	4.4	5.9	4.1	1.4	3.8	1.7	3.0	3.0	3.3
Japan	-1.1	0.2	3.2	-2.0	1.4	2.1	1.0	1.5	1.7
United Kingdom	2.8	3.3	3.0	2.2	1.9	2.7	2.9	2.6	2.5
Euro Area (2)	1.9	3.9	2.8	0.8	1.2	0.8	1.6	1.5	1.7
Germany	0.7	3.3	1.9	0.5	0.5	0.0	0.6	0.9	1.4
Developing Countries	-0.3	6.1	5.3	-0.4	3.7	4.5	5.5	4.7	4.7
Asia	-2.2	8.6	5.8	0.9	6.1	6.3	5.9	5.2	5.2
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	7.9	8.0
Latin America	1.2	4.3	4.5	-1.3	1.5	2.4	5.0	4.1	4.2
Mexico	2.9	5.5	4.8	-1.3	2.0	2.1	4.9	4.2	4.3
Brazil	-1.7	3.5	3.9	-0.9	4.2	0.8	4.8	2.8	2.9
CONSUMER PRICES (3)									
Industrial Countries	0.9	1.1	1.7	0.9	2.1	1.3	1.8	1.2	1.5
of which:									
Canada	1.1	2.4	3.1	1.1	3.8	1.7	2.3	1.7	2.0
Japan	0.7	-1.1	-1.2	-1.3	-0.5	-0.5	0.4	-0.6	0.2
United Kingdom (4)	1.4	1.2	1.0	1.0	1.5	1.3	1.4	1.9	2.0
Euro Area (2)	0.9	1.5	2.5	2.1	2.3	2.0	2.3	1.7	1.8
Germany	0.3	1.1	1.7	1.5	1.2	1.2	2.1	1.1	1.4
Developing Countries	9.0	4.6	4.1	2.8	2.9	3.0	3.9	3.2	3.3
Asia	4.4	0.1	1.8	1.1	0.6	2.1	3.0	2.6	2.8
Korea	5.8	1.2	2.6	3.4	3.4	3.5	3.4	3.8	3.3
China	-1.2	-1.0	0.9	-0.1	-0.6	2.6	3.2	2.1	2.9
Latin America	15.4	12.5	8.4	5.3	6.4	5.0	5.6	3.9	4.2
Mexico	17.3	13.5	8.7	5.1	5.3	3.9	5.3	3.2	3.8
Brazil	2.0	8.4	6.4	7.5	10.7	11.5	7.2	6.3	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.

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

	2004				Projected 2005				Projected 2006			
Measure and country	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
REAL GDP (1)	Quarterly changes at an annual rate											
Total foreign	4.6	3.6	2.7	3.1	3.0	3.3	3.4	3.5	3.5	3.4	3.4	3.4
Industrial Countries	3.2	2.8	1.5	1.4	2.0	2.3	2.5	2.6	2.7	2.6	2.5	2.5
of which:												
Canada	2.8	4.5	2.9	1.7	2.4	2.7	3.3	3.4	3.5	3.3	3.2	3.1
Japan	6.0	-1.0	-1.1	0.5	1.8	1.4	1.2	1.5	1.6	1.7	1.7	1.8
United Kingdom	2.4	4.2	2.1	2.9	2.1	2.8	2.8	2.8	2.5	2.5	2.5	2.5
Euro Area (2)	3.0	1.9	1.0	0.6	1.4	1.5	1.5	1.6	1.7	1.7	1.7	1.7
Germany	2.0	1.4	0.1	-0.9	0.6	0.9	1.0	1.2	1.3	1.4	1.4	1.4
Developing Countries	6.9	4.9	4.5	5.7	4.6	4.8	4.7	4.7	4.7	4.7	4.7	4.7
Asia	7.8	4.6	5.2	5.9	5.0	5.4	5.2	5.3	5.2	5.2	5.2	5.2
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	7.9	7.9	7.9	7.9	8.0	8.0	8.0	8.0
Latin America	6.2	4.9	3.9	5.2	4.1	4.1	4.1	4.1	4.2	4.2	4.2	4.2
Mexico	5.6	4.5	3.8	5.5	4.2	4.2	4.2	4.2	4.3	4.3	4.3	4.3
Brazil	7.3	6.0	4.4	1.7	2.8	2.8	2.8	2.8	2.9	2.9	2.9	2.9
CONSUMER PRICES (3)	Four-quarter changes											
Industrial Countries	0.9	1.5	1.5	1.8	1.5	1.3	1.4	1.2	1.5	1.5	1.5	1.5
of which:												
Canada	0.9	2.2	2.0	2.3	2.2	1.8	1.9	1.7	1.8	1.9	2.0	2.0
Japan	-0.3	-0.2	-0.1	0.4	-0.4	-0.3	-0.2	-0.6	-0.0	0.1	0.2	0.2
United Kingdom (4)	1.2	1.4	1.3	1.4	1.6	1.8	2.0	1.9	1.9	1.9	1.9	2.0
Euro Area (2)	1.7	2.3	2.3	2.3	2.0	1.8	1.8	1.7	2.0	1.9	1.9	1.8
Germany	1.0	1.9	2.0	2.1	1.7	1.4	1.3	1.1	1.5	1.4	1.4	1.4
Developing Countries	3.0	3.7	4.5	3.9	3.4	3.2	2.8	3.2	3.5	3.4	3.4	3.3
Asia	2.3	3.4	4.3	3.0	2.7	2.2	1.8	2.6	3.0	2.9	2.9	2.8
Korea	3.2	3.4	4.3	3.4	3.3	3.8	3.2	3.8	3.9	3.7	3.6	3.3
China	2.8	4.4	5.3	3.2	2.5	1.5	0.8	2.1	2.8	2.8	2.9	2.9
Latin America	4.7	4.6	5.2	5.6	4.8	4.9	4.4	3.9	4.4	4.4	4.3	4.2
Mexico	4.3	4.3	4.8	5.3	4.3	4.3	3.9	3.2	3.9	4.0	3.9	3.8
Brazil	6.8	5.5	6.8	7.2	7.3	7.4	6.6	6.3	5.6	5.3	5.2	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.

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OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	1998	1999	2000	2001	2002	2003	------ 2004	Projected 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	-0.8	-0.1	-0.3
Exports of G&S	0.3	0.6	0.7	-1.3	0.3	0.6	0.6	0.9	0.8
Imports of G&S	-1.4	-1.6	-1.6	1.1	-1.3	-0.7	-1.4	-1.0	-1.1
Percentage change, Q4/Q4									
Exports of G&S	2.6	5.6	6.5	-11.9	3.5	6.1	6.0	8.7	7.5
Services	4.4	5.3	1.8	-8.9	9.8	3.8	4.4	7.1	6.2
Computers	7.3	13.4	22.7	-23.5	-1.0	11.2	5.7	17.3	14.4
Semiconductors	9.5	34.6	27.6	-34.6	9.9	38.8	-5.8	24.1	29.1
Other Goods 1/	1.2	3.3	5.9	-10.2	0.4	5.0	7.5	8.1	6.6
Imports of G&S	11.0	12.1	11.2	-7.6	9.7	4.9	9.6	6.2	6.8
Services	10.4	6.5	10.7	-5.9	8.9	3.7	2.1	4.0	4.5
Oil	4.2	-3.4	13.3	3.7	4.2	1.8	10.2	-5.5	1.0
Computers	26.4	26.0	13.9	-13.6	13.4	16.9	22.3	14.7	17.5
Semiconductors	-7.7	34.2	22.8	-51.1	10.0	0.3	9.1	22.6	29.1
Other Goods 2/	11.2	12.9	10.5	-6.5	9.9	4.9	10.5	8.1	7.2
Billions of Chained 2000 Dollars									
Net Goods & Services	-203.8	-296.3	-379.5	-399.1	-472.0	-518.5	-583.2	-626.6	-647.7
Exports of G&S	966.5	1008.2	1096.3	1036.7	1012.4	1031.8	1120.4	1200.0	1295.1
Imports of G&S	1170.3	1304.5	1475.8	1435.8	1484.4	1550.2	1703.6	1826.5	1942.8
Billions of dollars									
US CURRENT ACCOUNT BALANCE	-209.6	-296.8	-413.5	-385.7	-473.9	-530.7	-669.4	-808.0	-876.6
Current Acct as Percent of GDP	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-5.7	-6.5	-6.7
Net Goods & Services (BOP)	-164.9	-263.3	-378.4	-362.7	-421.7	-496.5	-617.1	-715.9	-744.6
Investment Income, Net	8.3	18.4	25.3	28.7	12.6	38.8	26.6	-5.9	-45.9
Direct, Net	65.5	78.2	94.9	115.9	100.8	118.9	129.4	152.9	168.6
Portfolio, Net	-57.2	-59.8	-69.7	-87.2	-88.2	-80.1	-102.8	-158.8	-214.5
Other Income & Transfers,Net	-53.0	-52.0	-60.4	-51.7	-64.8	-72.9	-79.0	-86.1	-86.1

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

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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	-515.3	-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.

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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	-1.3	-0.6	0.6	0.0	-0.3	-0.5	0.2	-0.3	-0.6
Exports of G&S	0.7	0.7	0.6	0.3	0.8	0.9	0.9	1.0	0.7	0.8	0.8	0.9
Imports of G&S	-1.5	-1.8	-0.7	-1.6	-1.4	-0.3	-0.8	-1.3	-1.2	-0.6	-1.1	-1.5
Percentage change from previous period, s.a.a.r.												
Exports of G&S	7.3	7.3	6.0	3.3	7.9	8.8	8.5	9.8	6.5	7.6	7.4	8.5
Services	3.4	10.2	-1.9	6.4	7.7	7.2	7.0	6.7	6.5	6.4	6.1	5.9
Computers	-8.3	-1.8	22.4	13.1	25.1	15.9	14.3	14.3	14.4	14.4	14.4	14.4
Semiconductors	12.5	-10.1	-20.7	-1.9	2.3	38.7	29.2	29.2	29.1	29.1	29.1	29.1
Other Goods 1/	10.1	7.7	11.1	1.6	7.4	7.5	7.7	9.9	4.8	6.7	6.5	8.3
Imports of G&S	10.6	12.6	4.6	10.9	9.3	1.9	5.3	8.5	7.7	3.5	6.8	9.3
Services	1.1	10.7	2.8	-5.6	4.8	2.9	3.8	4.4	4.4	4.6	4.6	4.6
Oil	39.0	-33.1	2.2	55.4	4.1	-31.4	-7.9	21.1	12.7	-24.3	-1.1	23.3
Computers	12.8	38.6	29.9	10.0	8.2	16.3	17.3	17.4	17.5	17.5	17.5	17.5
Semiconductors	42.2	21.2	7.4	-23.6	13.7	19.4	28.9	29.2	29.1	29.1	29.1	29.1
Other Goods 2/	8.9	19.6	3.7	10.3	11.4	7.3	6.9	6.6	6.7	7.2	7.5	7.6
Billions of Chained 2000 Dollars, s.a.a.r.												
Net Goods & Services	-550.1	-580.3	-583.2	-619.0	-636.8	-620.5	-619.9	-629.1	-644.4	-637.4	-646.1	-662.8
Exports of G&S	1095.4	1114.8	1131.1	1140.3	1162.1	1186.8	1211.2	1239.7	1259.4	1282.7	1305.8	1332.7
Imports of G&S	1645.5	1695.1	1714.3	1759.3	1798.9	1807.4	1831.1	1868.8	1903.8	1920.1	1951.9	1995.5
Billions of dollars, s.a.a.r.												
US CURRENT ACCOUNT BALANCE	-589.6	-658.5	-660.9	-768.6	-790.1	-797.8	-809.7	-834.2	-873.3	-858.7	-872.2	-902.1
Current Account as % of GDP	-5.1	-5.6	-5.6	-6.4	-6.5	-6.4	-6.5	-6.6	-6.8	-6.6	-6.6	-6.7
Net Goods & Services (BOP)	-555.3	-605.3	-623.5	-684.2	-701.7	-712.6	-717.6	-731.8	-747.7	-734.5	-739.8	-756.2
Investment Income, Net	54.3	26.3	26.8	-0.8	4.9	-1.9	-8.3	-18.3	-32.3	-40.8	-48.6	-61.7
Direct, Net	139.1	125.1	125.6	128.0	140.1	152.7	158.0	160.7	160.2	165.2	173.0	176.1
Portfolio, Net	-84.8	-98.8	-98.8	-128.8	-135.2	-154.6	-166.3	-178.9	-192.5	-206.0	-221.6	-237.8
Other Inc. & Transfers, Net	-88.5	-79.5	-64.3	-83.6	-93.3	-83.4	-83.8	-84.2	-93.3	-83.4	-83.8	-84.2

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