

Prefatory Note

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Part 1

June 23, 2004

CURRENT ECONOMIC AND FINANCIAL CONDITIONS

Summary and Outlook

June 23, 2004

Summary and Outlook

Domestic Developments

Incoming data have confirmed our view that the economic expansion is on a solid footing. Although consumer spending in the current quarter has fallen short of our expectations, housing demand has been stronger than we had anticipated, and business fixed investment has remained on track for a considerable gain. In addition, hiring has been robust this spring, and manufacturing production advanced strongly in April and May. We estimate that real GDP increased at an annual rate of 4-3/4 percent in the second quarter, about the same pace as in the first quarter.

Looking ahead, the contour of our projection for economic activity over the next year and a half is little changed from the last Greenbook. Continued strength in final demand and an upswing in inventory accumulation should foster a sizable advance in output in the second half of the year. We expect that growth will slow in 2005 to a rate of 3-1/2 percent, as a result of fiscal policy that will be slightly restrictive after providing substantial stimulus for several years and monetary policy that will be less accommodative than in the past few years. Indeed, our forecast is predicated on a marked increase in the federal funds rate over the next year and a half, albeit a smaller one than anticipated by financial market participants.

Actual output is about 1-1/4 percent below potential in the second quarter according to our latest estimate, which incorporates a downward adjustment to potential that includes the effect of higher energy prices on structural productivity as well as a reassessment of the trend in hours worked. With actual output rising more rapidly than potential in our forecast, the output gap shrinks appreciably by the end of 2005, and the unemployment rate falls to 5-1/4 percent—just above our estimate of the NAIRU.

Core CPI inflation has come in higher than we had projected in the last Greenbook, and we have marked up our projection of inflation going forward. However, we still think that recent increases in core prices have been exacerbated by transitory factors, such as the pass-through of large increases in energy prices and non-energy import prices. The diminishing influence of these transitory factors and continued slack in resource utilization should lead to some moderation in core inflation next year. Our forecast calls for core PCE prices to rise at an annual rate of 1.7 percent in the second half of 2004 and 1.5 percent in 2005. Overall inflation should slow more sharply next year, primarily because of the direct effect of declining energy prices.

Key Background Factors

Financial market participants have reacted to stronger-than-expected economic data, particularly regarding employment, by shifting up the path anticipated for the federal funds rate. Futures quotes imply that market participants expect the funds rate to rise fairly steeply, reaching 3-1/2 percent by the fourth quarter of 2005. Our forecast also incorporates a higher path for the funds rate than it did in April, including an earlier onset of policy tightening, but our projected path continues to lie below the one expected by the market. We have assumed that the federal funds rate will be raised to 1-3/4 percent by the end of this year and to 3 percent by the end of 2005.

Yields on nominal long-term Treasuries and private debt have moved up about 1/4 percentage point since the end of April. Yields on inflation-indexed securities have risen by less; together with other indicators of inflation expectations, this differential suggests that the increase in nominal yields has been partly in real yields and partly in inflation compensation. We anticipate that market participants will gradually come to share our expectation of a less-steep trajectory for the funds rate, roughly offsetting the rise in long-term rates that would otherwise accompany a tightening of policy. Therefore, our forecast is conditioned on rates on long-term Treasuries holding about steady at their current levels for the rest of this year and through 2005.

Broad indexes of equity prices are down about 1 percent, on balance, since the April Greenbook. The negative effect on equity prices of the run-up in interest rates was apparently counterbalanced by growing confidence in the strength of the economic expansion and the accompanying implications for corporate earnings. We had expected some upward drift in equity values over the past two months, so we have lowered the projected path of stock prices a bit less than 2 percent. As in our previous forecast, we assume that equity prices will rise at an annual rate of 6-1/2 percent over the forecast period, roughly maintaining risk-adjusted parity with the projected yield on long-term Treasury securities.

As in the last Greenbook, we expect that federal fiscal policy will provide considerable stimulus to economic activity through the end of this year before turning slightly restrictive in 2005 owing to the expiration of the partial-

expensing allowances for business investment.¹ Because individual income tax refunds came in somewhat weaker this spring than we had projected and final tax payments a little stronger, we have boosted slightly our forecast of the effective tax rate (roughly speaking, the ratio of taxes to NIPA personal income). Developments on the spending side are proceeding about as we had expected. Although the House and the Senate have not agreed on a budget resolution for fiscal 2005, the appropriations committees in both houses are working with allocations for discretionary spending totaling about \$820 billion (excluding Iraq-related outlays), an amount that is about consistent with our previous projection. In May the Administration requested \$25 billion of budget authority for military and reconstruction activities in Iraq, and it has announced its intention to seek substantial additional funds for this purpose; this outlook is also quite close to our earlier assumption. All told, we expect the federal budget deficit to be \$428 billion in fiscal 2004, \$21 billion below our April forecast, and \$344 billion in fiscal 2005, \$14 billion below our previous forecast.

The budget pressures faced by state and local governments are easing somewhat, primarily because of the strengthening of economic activity and the resulting pickup in tax receipts. Therefore, we continue to expect less spending restraint than has been the case over the past couple of years.

Since the April Greenbook, we have shifted up the projected path of the real trade-weighted exchange rate about 1 percent in the second half of 2004. In addition, with the faster tightening of monetary policy in this forecast, we have reduced the assumed depreciation of the dollar during 2005. Our outlook for foreign GDP growth is very close to that in the last Greenbook; we anticipate that real trade-weighted foreign growth will be just short of 4 percent this year and about 3-1/2 percent next year.

The spot price of West Texas intermediate (WTI) crude oil moved above \$40 per barrel in May but has since fallen back to around \$38 per barrel, about \$1 per barrel above its level at the end of April. Rising global demand and intensifying worries about terrorism and political instability in major exporting countries seem to have been the key factors provoking this increase. These same factors have also driven up futures prices—by about \$3 per barrel, on net,

1. We continue to assume that the major changes in the individual income tax enacted in 2003 (the child tax credit, marriage penalty relief, and expanded 10 percent bracket) will be extended for next year and beyond, although progress toward that end is not yet evident. Recently the House and the Senate have passed bills repealing the corporate tax exclusion for extraterritorial income; that exclusion had been declared in violation of WTO rules. The bills differ in many of their provisions, and the timing of conference action is unclear. In any event, neither bill would likely have a large effect on the budget outlook or a material effect on business investment over our projection interval.

over the entire forecast period. However, futures quotes still imply a gradual decline in prices over the coming year and a half, as global production increases and oil inventories rise. In line with these quotes, we project that the price per barrel of WTI will edge down to roughly \$37 by the fourth quarter of 2004 and roughly \$34 by the fourth quarter of 2005.

Recent Developments and the Near-Term Outlook

We estimate that real GDP rose at an annual rate of 4-3/4 percent in the second quarter, quite close to our projection in the April Greenbook. Real final demand appears to have advanced more than 5 percent this quarter, but a swing to inventory liquidation in the motor vehicle sector has provided some offset.

Payroll employment has surged for three months in a row, and we are looking for further increases in the neighborhood of 300,000 jobs in each of the next several months. The recent strength in hiring should draw more people back into the labor force, nudging up the participation rate; even so, we anticipate that the unemployment rate will inch down in coming months.

Manufacturing production climbed 0.7 percent in April and 0.9 percent in May. For the second quarter as a whole, we estimate that factory output excluding motor vehicles and parts increased at an annual rate of about 10 percent. However, motor vehicle assemblies declined, as firms trimmed outsized inventory positions. Capacity utilization in manufacturing has rebounded nearly 4 percentage points from its trough last spring but, at 76.4 percent in May, remains about 3-1/2 percentage points below its 1972-2003 average.

On the spending side, we now project that real consumer outlays rose at an annual rate of roughly 3-1/2 percent in the second quarter, about 1-3/4 percentage points less than we had anticipated in the April Greenbook. Purchases of goods excluding motor vehicles were disappointing in April and, to a lesser extent, in May. However, real disposable income is poised to register a sizable gain this quarter despite the run-up in energy prices, and consumer confidence remains at a favorable level. Based on these fundamentals, our projection is that overall consumer spending will quickly resume its solid uptrend.

Single-family housing starts have edged above their rapid first-quarter pace, averaging 1.63 million units (annual rate) in April and May. We estimate that real residential investment shot up at an annual rate of nearly 20 percent in the second quarter, driven by the strong pace of starts, a spurt in real estate commissions stemming from the extraordinary level of home sales, and a rise in spending on home improvements that is likely to be brisk.

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

Measure	2004:Q1		2004:Q2	
	Apr. GB	June GB	Apr. GB	June GB
Real GDP	5.2	4.4	4.6	4.7
Private domestic final purchases	4.3	4.4	6.4	5.6
Personal consumption expenditures	4.0	4.0	5.1	3.4
Residential investment	3.8	4.5	8.4	18.8
Business fixed investment	6.9	6.7	14.2	14.2
Government outlays for consumption and investment	3.6	3.5	1.9	3.0
	Contribution to growth (percentage points)			
Inventory investment	1.0	.8	-.8	-.6
Net exports	-.2	-.7	-.4	-.1

We project that real business purchases of equipment and software climbed at an annual rate of more than 15 percent this quarter. Outlays for motor vehicles and aircraft appear to have increased sharply, and the data on orders and shipments of durable goods through April point to a substantial increase in outlays for nontransportation equipment as well. The strength in purchases of nontransportation equipment has been broadly based, with notable gains over the past few months in all the major categories.

Construction of nonresidential structures moved up in March and April, pointing to an increase in the second quarter that may reverse the first-quarter decline. Viewed over a longer period, activity in this sector has yet to break out of the low range seen over the past year and a half.

Real federal defense spending increased modestly this quarter following a sizable jump last quarter, and nondefense spending appears to have been about unchanged. Real spending by state and local governments is estimated to have increased at an annual rate of 3 percent in the second quarter on the basis of a step-up in construction of roads and bridges.

We estimate that net exports have been a roughly neutral influence on real GDP growth in the second quarter after arithmetically deducting nearly 3/4 percentage point from growth in the first quarter. The release of international trade data for April included the annual historical revisions and

incorporated a new seasonal adjustment procedure for oil imports that has noticeably altered the recent quarterly pattern. We now estimate that real imports climbed at an annual rate of about 10 percent in the first quarter, well above our previous projection; imports are on track for a gain about half as large in the current quarter, with that slowdown attributable almost entirely to a decline in oil imports on a seasonally adjusted basis. We project that real exports rose about 7-1/2 percent in the first quarter and will repeat that performance in the second quarter.

Core consumer price inflation, as measured by the CPI, came in above our expectations for April and May but was more moderate than in March. After a 0.2 percent increase in the core CPI last month, our forecast calls for similar-sized increases in each of the next few months. The BEA's estimate of core consumer prices that are not based on market transactions fell in March and April, holding down the increase in PCE prices. Altogether, we estimate that core PCE prices rose at an annual rate of 1.6 percent in the second quarter, in line with our April projection. Overall consumer prices this quarter have been boosted further by a surge in energy prices and a sizable rise in food prices; based on survey measures and futures markets quotes, we project that consumer energy prices will be about flat in June and then turn down in subsequent months. We estimate that overall PCE inflation will be 3.0 percent in the second quarter.

The Longer-Term Outlook for the Economy

We expect output, supported by its recent momentum and strong fundamentals, to increase at an annual rate of around 5 percent in the second half of 2004. In 2005, less-accommodative financial conditions and a turn in fiscal policy from stimulative to restrictive should cause growth to slow to about 3-1/2 percent. Our outlook for the next year and a half is little changed since the last Greenbook, with the damping effects of the revisions to interest rates and other background factors partly offset by our assessment that, in a sustained economic expansion, households and firms will have the wherewithal and inclination to undertake somewhat more spending than we previously thought.

Household spending. Our forecast calls for real consumer spending to pick up to a 4-1/2 percent pace in the second half of the year. An improving labor market and smaller increases in consumer prices should generate a sharp acceleration in real pre-tax income that will more than offset a waning of the stimulus from last year's tax cuts. In 2005, disposable income growth is likely to slow; in addition, the rise in interest rates will tend to hold the growth of consumption below that of income, causing the personal saving rate to move up. Still, we project that real consumer spending will rise 3-3/4 percent next year.

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

Measure	2004		2005
	H1	H2	
Real GDP	4.6	5.0	3.6
Previous	4.9	5.1	3.8
Final sales	4.5	4.3	3.6
Previous	4.8	4.7	3.6
PCE	3.7	4.5	3.8
Previous	4.5	4.3	4.0
Residential investment	11.4	-4.9	-1.8
Previous	6.1	-2.9	-1.2
BFI	10.4	15.6	9.0
Previous	10.5	16.6	7.8
Government purchases	3.2	1.9	2.2
Previous	2.7	1.7	2.1
Exports	7.4	10.2	8.0
Previous	6.9	11.7	9.1
Imports	7.9	10.8	8.1
Previous	6.8	9.2	8.6
	Contribution to growth (percentage points)		
Inventory change	.1	.7	.0
Previous	.1	.4	.2
Net exports	-4	-6	-4
Previous	-3	-2	-3

The factors bolstering future consumer spending should also support the demand for housing, but the considerable increase in mortgage rates this spring will provide an unfavorable overlay. We anticipate that the balance of these forces will leave single-family starts on a modest downward trajectory that averages 1.49 million units in 2005—a strong pace by historical standards, although below this year’s expected rate of 1.57 million units. Multifamily construction has been quite resilient during the past several quarters despite high vacancy rates, and we are forecasting that multifamily starts will stay around

350,000 units through the end of 2005. Taking these pieces together, real residential investment is projected to fall at an annual rate of 5 percent in the second half of this year and then to slip a further 2 percent next year.

Business spending. Supported by sustained increases in the demand for business output, strong profits, and a cost of capital that is held down by low interest rates and the partial-expensing tax provisions, business outlays for equipment and software should rise at a solid pace through the end of the year. The impending expiration of partial expensing will provide an additional boost to investment late in the year as firms pull investment forward; however, the payback for that extra boost will reduce investment next year. This effect should be most pronounced for non-high-tech equipment, which has a longer average service life and therefore benefits to a greater extent from the partial-expensing provisions. All told, we are looking for real business investment in equipment and software to jump at an annual rate of 19 percent in the second half of 2004 and then to rise nearly 10 percent in 2005.

We have written down a moderate increase in business construction spending over the next year and a half. After holding roughly flat since the end of 2002, real investment in nonresidential buildings is expected to move up in coming quarters because of the further recovery in business activity and hiring. The high level of energy prices should support spending in the drilling and mining sector during the forecast period.

The ratio of business inventories to sales appears to be below its downward trend, and we anticipate that firms will gradually increase inventory investment in order to bring that ratio back in line with the trend. The resultant faster pace of inventory accumulation provides a small positive contribution to output growth in our forecast.

Government spending. We project that real federal outlays will rise at a pace close to 2 percent over the next year and a half. After increasing rapidly in the past several years, defense spending appears likely to move up more slowly in the period ahead. Nondefense spending is also on track for moderate gains. With many state and local governments experiencing improving budget situations, we anticipate that real outlays in this sector will increase at an annual rate of 1-1/2 percent in the second half of 2004 and 2-1/2 percent in 2005.

Net exports. Supported by solid growth abroad and the effects of past dollar depreciation, real exports are expected to climb at an annual rate of 10 percent in the second half of this year and 8 percent next year. We project that real imports, spurred by rising domestic demand, will increase at roughly the same

pace as exports. Nonetheless, because imports are considerably larger than exports, net exports should arithmetically deduct about 1/2 percentage point from real GDP growth in the second half of 2004 and a bit less in 2005. (*The International Developments section provides more detail on the outlook for the external sector.*)

Aggregate Supply, the Labor Market, and Inflation

We now estimate that the gap between actual output and potential output—for both the recent past and the forecast period—is somewhat narrower than in the April Greenbook. The revision reflects primarily a downward adjustment to potential output stemming from two changes: We reduced trend hours growth from 2001 through 2005 based on a reassessment of recent population trends, and we trimmed multifactor productivity growth from 2003 through 2005 to incorporate the effect of higher actual and expected energy prices on capital obsolescence.² Actual output now appears to be about 1-1/4 percent below our revised estimate of potential output in the current quarter, and above-trend growth in real GDP during the next year and a half eliminates much of this gap by the end of 2005.

We have boosted our projection of inflation, especially in the near-term. However, we continue to expect that the diminishing influence of some forces that have temporarily pushed up inflation, as well as the remaining slack in resource utilization, will keep inflation reasonably well contained over the forecast period.

Productivity and the labor market. Private payrolls have jumped by nearly 1 million workers in the past three months. We expect further hefty gains in payrolls over the next several quarters and then a gradual moderation in the rate of increase in employment. Despite a rise in labor force participation induced by these improving labor market conditions, our forecast calls for the unemployment rate to decline to 5-1/4 percent by the end of 2005.

The pickup in employment has been associated with an easing of labor productivity growth. Following a 5-1/2 percent surge last year, output per hour in the nonfarm business sector appears to have increased at an annual rate of 3 percent in the first half of 2004. We project that the average growth rate of

2. The Census Bureau recently published updated extrapolations of population growth beyond the Census year that are slightly below the estimated rates of increase in population reported in the Current Population Survey (CPS) for the past three years. The population growth rates published so far this year in the CPS are consistent with the new, lower projections, and we have reduced our estimate of trend population growth for the period after 2000 to a rate in line with the updated Census projections.

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

Measure	1974-95	1996-2001	2002	2003	2004	2005
Structural labor productivity	1.5	2.7	3.3	3.8	3.2	3.0
Previous	1.5	2.7	3.3	3.8	3.2	3.0
<i>Contributions¹</i>						
Capital deepening	.7	1.4	.7	.7	.9	1.1
Previous	.7	1.4	.6	.7	.9	1.1
Multifactor productivity	.5	1.1	2.4	2.8	2.0	1.6
Previous	.5	1.1	2.4	2.9	2.1	1.7
Labor composition	.3	.3	.3	.3	.3	.3
MEMO						
Potential GDP	3.0	3.4	3.5	3.9	3.5	3.5
Previous	3.0	3.4	3.6	4.1	3.6	3.6

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

1. Percentage points.

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

Measure	2002	2003	2004	2005
Output per hour, nonfarm business	4.3	5.4	2.2	2.0
Previous	4.3	5.4	2.7	1.6
Nonfarm private payroll employment	-.9	-.2	2.8	2.0
Previous	-.9	-.2	2.3	2.5
Household survey employment	.3	1.2	1.7	1.7
Previous	.3	1.2	1.7	1.9
Labor force participation rate ¹	66.5	66.1	66.2	66.5
Previous	66.5	66.1	66.4	66.6
Civilian unemployment rate ¹	5.9	5.9	5.3	5.2
Previous	5.9	5.9	5.4	5.2
MEMO				
GDP gap ²	2.1	1.7	.5	.5
Previous	2.4	2.2	.9	.7

1. Percent, average for the fourth quarter.

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

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

Measure	2002	2003	2004	2005
PCE chain-weighted price index	1.8	1.5	2.1	1.2
Previous	1.8	1.5	1.5	1.1
Food and beverages	1.4	2.6	2.9	2.0
Previous	1.4	2.6	1.8	1.6
Energy	7.9	7.8	7.6	-4.6
Previous	7.9	7.8	1.7	-2.7
Excluding food and energy	1.6	1.0	1.7	1.5
Previous	1.6	1.0	1.4	1.2
Consumer price index	2.2	1.9	2.8	1.5
Previous	2.2	1.9	1.8	1.3
Excluding food and energy	2.0	1.2	2.3	2.0
Previous	2.0	1.2	1.7	1.6
GDP chain-weighted price index	1.4	1.6	1.8	1.4
Previous	1.4	1.6	1.3	1.3
ECI for compensation of private industry workers ¹	3.2	4.0	4.0	4.2
Previous	3.2	4.0	3.7	3.9
NFB compensation per hour	1.8	4.5	4.3	4.1
Previous	1.8	4.0	3.6	3.8
Prices of core non-oil merchandise imports	.5	1.8	4.4	.7
Previous	.5	1.8	4.5	.4

1. December to December.

productivity over the next six quarters will slow to around 2 percent, well below our estimate of its underlying structural pace.

Prices and labor costs. Recent data on prices and wages point to a somewhat higher underlying rate of inflation than we had been assuming. In addition to the unexpectedly high readings on the core CPI, we have been surprised by the size of the increases in energy prices and core intermediate materials prices, both of which will likely be passed through to some degree into core consumer prices. Labor compensation has also risen more rapidly than we had anticipated, judging from the employment cost index for the first quarter and

compensation per hour in the nonfarm business sector for the past couple of quarters.

All told, these data have led us to mark up the projected core inflation rate in the second half of this year by nearly 1/2 percentage point, to 1.7 percent, and we expect some of that faster inflation to carry forward into next year. Still, we expect the rise in core prices to moderate in 2005 to 1.5 percent, as the impetus to inflation from recent increases in energy prices and non-energy import prices wanes. The decline in energy prices and a moderation in food prices should hold the rate of increase in overall PCE prices to an annual rate of 1.3 percent in the second half of this year and 1.2 percent next year.

Our forecast calls for the employment cost index to rise about 4 percent both this year and next—supported by the accumulated productivity gains of recent years and the tightening of the labor market. Benefit costs were boosted in the first quarter by a jump in contributions to retirement plans, but the rate of increase should ease somewhat going forward; wages and salaries are likely to pick up over time.

Financial Flows and Conditions

Domestic nonfinancial debt is anticipated to increase 7-3/4 percent this year—a bit slower than last year's pace—and to slow to 6-3/4 percent next year. We expect a slowdown in government and household borrowing next year to more than offset a pickup in the rate of business borrowing.

Household debt growth is projected to slow from last year's pace of 10-1/2 percent to 9-1/4 percent this year and 7-1/4 percent next year. This pattern reflects a deceleration in home mortgage debt, which is held back by the damping effect of smaller increases in house prices and the rise in mortgage rates relative to last year. In contrast, the growth rate of consumer credit is expected to pick up from last year's pace of 5 percent, to 6-1/2 percent next year, because of a step-up in household spending on big-ticket items as well as a reduced reliance on mortgage debt for the financing of household purchases.

We anticipate that borrowing by nonfinancial businesses will move up this year and next, as capital expenditures rise and the expiration of the partial-expensing provisions at year-end 2004 lowers the volume of internal funds available to finance those expenditures. With inventory investment projected to step up over the forecast period, we expect some shift back toward shorter-term financing after the sharp runoffs in commercial paper and bank loans in recent years. This year's projected increase in debt is smaller than that in the last Greenbook: Current-quarter data for nonfinancial bond issuance and C&I loans have been quite weak, and borrowing costs have been revised up a bit.

Federal sector debt is expected to increase 10-3/4 percent this year—roughly the same as last year’s pace—and then to increase 7-1/4 percent in 2005. This pattern tracks the expected path of the deficit, which has been revised down since the last Greenbook. Borrowing by state and local governments is expected to slow this year and next as a result of the brightening fiscal outlook and the damping effect of higher interest rates on advance-refunding activity.

Because of the increase in the funds rate anticipated this year, M2 growth is expected to slow significantly in coming quarters and to move up about 5 percent for the year as a whole, less than the rate of increase in nominal income. In 2005, tightening monetary policy raises the opportunity cost of holding M2 and pulls its growth rate down to about 2-1/2 percent for the year.

Alternative Simulations

In this section we evaluate several risks to the staff forecast using simulations of the FRB/US model. The first two scenarios examine the possibility that we have overestimated the restraint on prices from economic slack and from the stability of long-run inflation expectations. The next simulation explores the risk that inflation may slow markedly if competitive pressures substantially erode the markup of prices over unit labor costs. We then consider three aggregate demand scenarios. In the first, the personal saving rate rises more markedly than in the baseline. In the second, we reinterpret the likely sources of the recent strength in equipment spending and attribute less importance to tax incentives. The third demand scenario assumes that monetary policy is providing more stimulus to aggregate demand than in the baseline. In all these simulations, the federal funds rate is held at baseline. The final scenario assumes that the funds rate follows a path consistent with current readings from the futures market.

Less room to grow. In the baseline outlook, real activity expands briskly without putting much upward pressure on inflation, in part because slack in labor and product markets is still available to be taken up. In this scenario, we take a less optimistic view of supply-side conditions and assume that the NAIRU has been for some time and will continue to be 5-3/4 percent rather than 5 percent; we also assume that the rebound in labor force participation will be only half as great as in the baseline. The downward revision to the level of potential output (and therefore permanent income and corporate earnings) implies that the economy’s equilibrium real interest rate has been and will be higher than in the baseline. As a result, the baseline path for the funds rate delivers more stimulus, which roughly offsets the implied downward revision in permanent income and earnings; thus, real aggregate spending is largely unaffected. However, with the labor force growing more slowly, the

unemployment rate falls to 4-3/4 percent by the end of next year. Tighter labor and product market conditions boost core inflation to almost 2 percent in 2005.

Alternative Scenarios

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

Measure	2003: H2	2004		2005
		H1	H2	
<i>Real GDP</i>				
Baseline	6.2	4.6	5.0	3.6
Less room to grow	6.2	4.6	5.0	3.7
Higher inflation expectations	6.2	4.6	5.0	3.8
Lower markup	6.2	4.6	5.2	3.6
Higher saving rate	6.2	4.6	4.6	2.4
Stronger investment	6.2	4.6	5.0	4.3
Surging demand	6.2	4.6	5.9	4.5
Market-based funds rate	6.2	4.6	5.0	3.3
<i>Civilian unemployment rate¹</i>				
Baseline	5.9	5.6	5.3	5.2
Less room to grow	5.9	5.6	5.0	4.7
Higher inflation expectations	5.9	5.6	5.0	4.6
Lower markup	5.9	5.6	5.3	5.1
Higher saving rate	5.9	5.6	5.4	5.9
Stronger investment	5.9	5.6	5.3	4.9
Surging demand	5.9	5.6	5.1	4.5
Market-based funds rate	5.9	5.6	5.3	5.3
<i>PCE prices excluding food and energy</i>				
Baseline	1.1	1.7	1.7	1.5
Less room to grow	1.1	1.7	1.9	1.9
Higher inflation expectations	1.1	1.7	1.9	2.4
Lower markup	1.1	1.7	1.1	.7
Higher saving rate	1.1	1.7	1.7	1.4
Stronger investment	1.1	1.7	1.7	1.5
Surging demand	1.1	1.7	1.7	1.6
Market-based funds rate	1.1	1.7	1.7	1.4

1. Average for the final quarter of the period.

Higher inflation expectations. In the previous simulation, long-term inflation expectations were assumed to remain reasonably well anchored despite the combination of accelerating prices and a very accommodative stance of

monetary policy. In this scenario, these same conditions are accompanied by a gradual rise of 1 percentage point in long-term inflation expectations. As a result, the upward pressure on wages and prices is more intense, and core PCE inflation reaches 2-1/2 percent in 2005. Although nominal bond yields also rise in response to the shift in long-run inflation expectations, the increase is not enough—given the fixed funds-rate trajectory—to prevent a modest decline in real long-term interest rates over time. This decline provides a small stimulus to real activity late in 2005 and would provide more in the longer term unless offset by a tightening of monetary policy. If policymakers responded to these events by gradually raising the federal funds rate to 3-3/4 percent by late next year—a tightening roughly in line with the prescriptions of a Taylor rule under these circumstances and similar to market expectations—real GDP would increase 3-1/4 percent in 2005, and core PCE prices would rise 2-1/4 percent.

Lower markup. The markup of prices over unit labor costs in the nonfarm business sector is currently well above its long-run average. We believe that firms will be able to maintain an elevated level of profitability for at least a year or two, in part because we anticipate that future gains in compensation per hour will be moderate. However, there are risks that firms may bid up wages more than we have assumed in an effort to boost production and that competitive pressures may prevent firms from passing on increases in their costs to the extent that we project in the baseline. In this scenario, both developments occur: Nominal wages rise 3/4 percentage point faster than in the baseline, but competitive pressures are sufficiently strong to more than offset the faster growth in firms' unit labor costs, pushing core inflation down to only 3/4 percent in 2005. These developments boost the level of real labor income more than 2 percent relative to baseline by the end of next year. However, because of the accompanying reduction in corporate earnings and increase in real interest rates, real output is only slightly strengthened.

Higher saving rate. The personal saving rate is presently quite low by historical standards, and although we project it to move up modestly through the end of next year, we believe that this rise is just the beginning of a more-pronounced and longer-term adjustment. But in light of the recent softness in consumer spending, we may have misjudged the speed at which this adjustment will occur. In this scenario, the pace of overall consumer spending is about 1 percentage point slower than in the baseline through the second half of this year and in 2005. Because weaker spending leads to slower income growth, the personal saving rate rises to almost 4 percent by late next year, 1 percentage point above baseline. Under these conditions, real GDP increases only 2-1/2 percent in 2005, and the unemployment rate stands at just under 6 percent in late 2005. The resultant increase in slack causes inflation to be a bit lower.

Stronger investment. Expenditures on equipment and software have been rising at an average annual rate of about 15 percent in recent quarters. In the staff forecast, we attribute some of this strength to the partial-expensing provisions of the tax code and therefore expect that investment spending will weaken noticeably in 2005 after the provisions expire. However, gauging the effect of tax incentives on business investment is quite difficult, and in this scenario we assume that more of the recent pace of spending reflects a stronger underlying trend. This alternative interpretation implies both a smaller current contribution from partial expensing and a less-pronounced “pothole” in equipment spending next year. In total, real E&S outlays rise at about the same pace this year and 5 percentage points faster in 2005, boosting the increase in real GDP to 4-1/4 percent next year. With output growing more rapidly, the unemployment rate falls below 5 percent in 2005. Inflation is the same as in the baseline, in part because more-rapid investment spending boosts potential output.

Surging demand. The Greenbook baseline projects the level of real activity to be nearly 1/2 percent below potential late in 2005, even though the real funds rate over the projection period averages more than 2 percentage points below its mean of the past forty years. One way to characterize this outlook is that the stimulus to spending from a low funds rate is being muted by an equilibrium real rate of interest (a summary measure of the net effect of the medium-term forces influencing aggregate demand) that also has been, and will be for a while, low by historical standards. In this scenario, which repeats an exercise that we included in the last Greenbook, we instead assume that the restraining forces that have been holding down the equilibrium real rate fade away rapidly; accordingly, the magnitude of monetary stimulus is greater than in the baseline. Consistent with this assumption, real GDP advances at a rate of 6 percent in the second half of this year and 4-1/2 percent next year. By the end of 2005, this faster output growth is sufficient to bring the unemployment rate down to 4-1/2 percent and to cause inflation to be slightly higher than in the baseline.

Market-based funds rate. Quotes from futures markets are consistent with a federal funds rate that begins to rise at the forthcoming FOMC meeting and reaches 3-1/2 percent by the fourth quarter of 2005. Relative to baseline, adopting the market-based path for the funds rate limits the increase of real GDP in 2005 to 3-1/4 percent. The unemployment rate is a touch higher as a result, and inflation is a bit lower.

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

Measure	2004	2005
<i>Real GDP (percent change, Q4 to Q4)</i>		
Projection	4.8	3.6
Confidence interval		
Greenbook forecast errors ¹	3.4–6.2	1.6–5.6
FRB/US stochastic simulations	3.8–5.8	2.0–5.1
<i>Civilian unemployment rate (percent, Q4)</i>		
Projection	5.3	5.2
Confidence interval		
Greenbook forecast errors ¹	4.8–5.8	4.4–6.0
FRB/US stochastic simulations	4.8–5.7	4.2–6.1
<i>PCE prices excluding food and energy (percent change, Q4 to Q4)</i>		
Projection	1.7	1.5
Confidence interval		
Greenbook forecast errors ²	1.2–2.1	.6–2.3
FRB/US stochastic simulations	1.3–2.0	.7–2.2

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

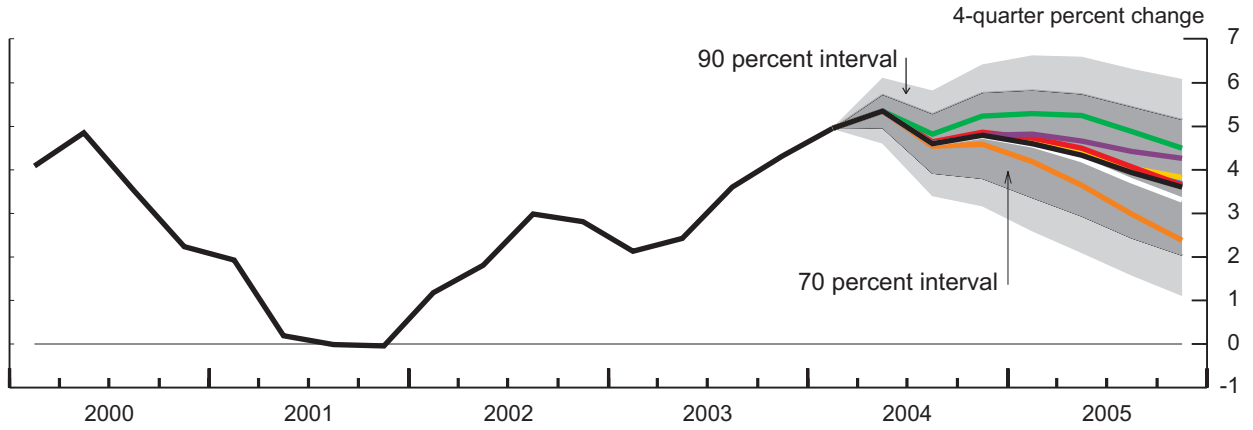
1. 1978–2003.
2. 1981–2003.

Forecast Confidence Intervals and Alternative Scenarios

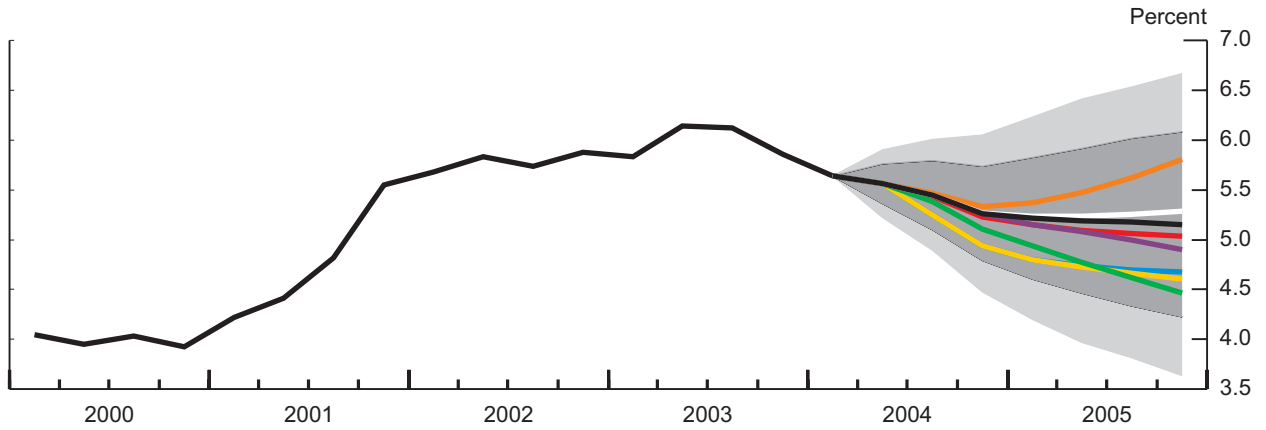
Confidence Intervals Based on FRB/US Stochastic Simulations

- Greenbook baseline
- Higher saving rate
- Less room to grow
- Stronger investment
- Higher inflation expectations
- Surging demand
- Lower markup
- Market-based funds rate

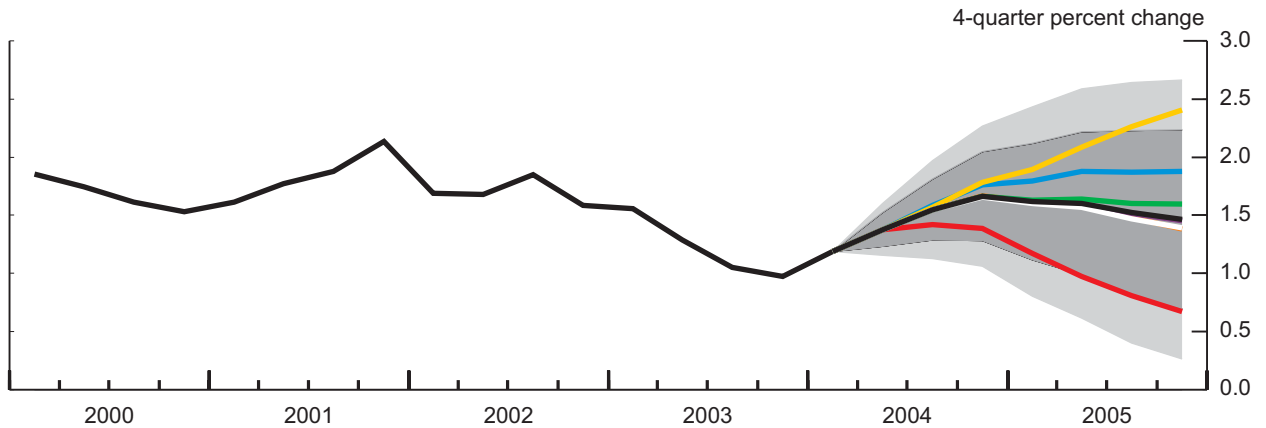
Real GDP



Unemployment Rate



PCE Prices excluding Food and Energy



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		
	04/28/04	06/23/04	04/28/04	06/23/04	04/28/04	06/23/04	04/28/04	06/23/04	04/28/04	06/23/04	
ANNUAL											
2001	2.9	2.9	0.5	0.5	2.4	2.4	2.8	2.8	4.7	4.7	
2002	3.8	3.8	2.2	2.2	1.5	1.5	1.6	1.6	5.8	5.8	
2003	4.8	4.8	3.1	3.1	1.7	1.7	2.3	2.3	6.0	6.0	
2004	6.7	6.9	5.1	4.9	1.5	1.9	1.9	2.5	5.5	5.5	
2005	5.4	5.5	4.3	4.1	1.1	1.3	1.2	1.6	5.3	5.2	
QUARTERLY											
2002	Q1	5.4	5.4	4.7	4.7	1.1	1.1	1.4	1.4	5.7	5.7
	Q2	3.9	3.9	1.9	1.9	1.5	1.5	3.4	3.4	5.8	5.8
	Q3	4.4	4.4	3.4	3.4	1.5	1.5	2.2	2.2	5.7	5.7
	Q4	3.1	3.1	1.3	1.3	1.7	1.7	2.0	2.0	5.9	5.9
2003	Q1	4.3	4.3	2.0	2.0	2.3	2.3	3.8	3.8	5.8	5.8
	Q2	4.2	4.2	3.1	3.1	1.1	1.1	0.7	0.7	6.1	6.1
	Q3	10.0	10.0	8.2	8.2	1.6	1.6	2.4	2.4	6.1	6.1
	Q4	5.7	5.7	4.1	4.1	1.5	1.5	0.7	0.7	5.9	5.9
2004	Q1	7.6	7.2	5.2	4.4	2.3	2.7	3.5	3.5	5.6	5.6
	Q2	6.2	7.4	4.6	4.7	1.6	2.6	2.2	4.5	5.6	5.6
	Q3	5.7	6.3	5.1	5.2	0.6	1.1	0.6	2.0	5.5	5.4
	Q4	5.8	5.7	5.1	4.9	0.7	0.8	0.9	1.0	5.4	5.3
2005	Q1	5.5	5.3	4.0	3.7	1.4	1.5	1.2	1.3	5.3	5.2
	Q2	5.1	4.9	3.8	3.6	1.2	1.3	1.3	1.5	5.3	5.2
	Q3	4.9	4.9	3.7	3.6	1.2	1.3	1.4	1.7	5.2	5.2
	Q4	4.9	4.8	3.6	3.5	1.2	1.3	1.4	1.7	5.2	5.2
TWO-QUARTER³											
2002	Q2	4.7	4.7	3.3	3.3	1.3	1.3	2.4	2.4	0.2	0.2
	Q4	3.8	3.8	2.3	2.3	1.6	1.6	2.1	2.1	0.1	0.1
2003	Q2	4.2	4.2	2.5	2.5	1.7	1.7	2.2	2.2	0.2	0.2
	Q4	7.8	7.8	6.2	6.2	1.6	1.6	1.5	1.5	-0.2	-0.2
2004	Q2	6.9	7.3	4.9	4.6	1.9	2.6	2.9	4.0	-0.3	-0.3
	Q4	5.7	6.0	5.1	5.0	0.6	1.0	0.8	1.5	-0.2	-0.3
2005	Q2	5.3	5.1	3.9	3.7	1.3	1.4	1.3	1.4	-0.1	-0.1
	Q4	4.9	4.9	3.6	3.5	1.2	1.3	1.4	1.7	-0.1	0.0
FOUR-QUARTER⁴											
2001	Q4	2.4	2.4	-0.0	-0.0	2.4	2.4	1.8	1.8	1.7	1.7
2002	Q4	4.2	4.2	2.8	2.8	1.4	1.4	2.2	2.2	0.3	0.3
2003	Q4	6.0	6.0	4.3	4.3	1.6	1.6	1.9	1.9	0.0	0.0
2004	Q4	6.3	6.7	5.0	4.8	1.3	1.8	1.8	2.8	-0.5	-0.6
2005	Q4	5.1	5.0	3.8	3.6	1.3	1.4	1.3	1.5	-0.2	-0.1

1. For all urban consumers.

2. Level, except as noted.

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

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

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

June 23, 2004

Item	Units ¹	- - Projected - -								
		1997	1998	1999	2000	2001	2002	2003	2004	2005
Expenditures										
Nominal GDP	Bill. \$	8304.3	8747.0	9268.4	9817.0	10100.8	10480.8	10987.9	11746.4	12391.0
Real GDP	Bill. Ch. \$	8703.5	9066.9	9470.3	9817.0	9866.6	10083.0	10398.0	10909.6	11358.5
Real GDP	% change	4.3	4.5	4.7	2.2	-0.0	2.8	4.3	4.8	3.6
Gross domestic purchases		5.1	5.5	5.5	3.0	0.1	3.6	4.2	5.0	3.8
Final sales		3.7	4.8	4.2	2.9	1.1	1.8	4.4	4.4	3.6
Priv. dom. final purchases		5.2	6.4	5.3	4.3	0.8	2.3	4.7	5.1	4.1
Personal cons. expenditures		4.3	5.4	4.9	4.1	2.7	2.7	4.0	4.1	3.8
Durables		9.9	14.4	7.3	4.7	9.4	1.8	11.1	4.9	7.3
Nondurables		2.5	4.7	4.9	3.0	1.7	2.8	4.9	4.5	4.8
Services		4.0	3.8	4.4	4.5	1.8	2.9	2.2	3.8	2.7
Business fixed investment		11.4	10.9	7.7	7.8	-10.2	-2.8	7.4	13.0	9.0
Equipment & Software		13.8	13.5	10.8	7.5	-9.4	1.6	10.0	16.4	9.6
Nonres. structures		4.6	4.0	-0.9	8.8	-12.4	-14.9	-0.9	1.6	6.5
Residential structures		3.1	10.3	3.6	-1.8	1.7	7.1	9.5	2.9	-1.8
Exports		8.3	2.6	5.6	6.5	-11.5	3.3	6.4	8.8	8.0
Imports		14.3	11.0	12.1	11.2	-7.4	9.4	4.5	9.3	8.1
Gov't. cons. & investment		1.2	3.3	4.2	0.4	3.6	4.5	2.1	2.6	2.2
Federal		-0.5	0.1	4.2	-2.2	6.3	10.1	5.9	4.2	1.7
Defense		-1.5	-1.2	4.3	-3.5	6.6	10.9	8.0	4.9	1.4
State & local		2.2	5.1	4.2	1.7	2.3	1.6	0.1	1.6	2.5
Change in bus. inventories	Bill. Ch. \$	71.2	72.6	68.9	56.5	-36.0	5.7	-0.8	30.3	64.5
Nonfarm		68.5	71.2	71.5	57.8	-36.3	9.3	0.5	31.7	63.4
Net exports		-104.6	-203.8	-296.2	-379.5	-398.1	-470.6	-509.1	-547.7	-594.6
Nominal GDP	% change	5.9	5.7	6.3	4.6	2.4	4.2	6.0	6.7	5.0
GDP Gap ²	%	-0.9	-1.6	-2.4	-2.4	0.4	1.6	2.2	1.0	0.5
Employment and Production										
Nonfarm payroll employment	Millions	122.8	125.9	129.0	131.8	131.8	130.3	129.9	131.7	134.7
Unemployment rate	%	4.9	4.5	4.2	4.0	4.7	5.8	6.0	5.5	5.2
Industrial prod. index	% change	8.1	4.4	4.9	2.3	-5.2	1.3	1.5	7.1	4.3
Capacity util. rate - mfg.		82.6	82.0	81.4	81.1	75.4	73.9	73.4	76.9	79.7
Housing starts	Millions	1.47	1.62	1.64	1.57	1.60	1.70	1.85	1.92	1.84
Light motor vehicle sales		15.13	15.52	16.90	17.36	17.12	16.79	16.65	16.97	17.59
North Amer. produced		13.19	13.48	14.41	14.48	14.04	13.50	13.34	13.57	14.09
Other		1.95	2.03	2.49	2.87	3.08	3.30	3.31	3.40	3.50
Income and Saving										
Nominal GNP	Bill. \$	8337.3	8768.3	9302.2	9855.9	10135.9	10502.3	11031.6	11804.7	12409.4
Nominal GNP	% change	5.8	5.5	6.5	4.7	2.6	3.8	6.3	6.4	4.6
Nominal personal income		6.4	7.0	5.5	7.1	2.4	2.4	4.5	6.8	5.9
Real disposable income		4.3	5.6	2.8	4.4	1.3	3.5	3.8	4.6	4.2
Personal saving rate	%	3.6	4.3	2.4	2.3	1.7	2.3	2.1	2.4	2.7
Corp. profits, IVA & CCAdj.	% change	9.1	-10.0	9.6	-8.6	8.7	8.3	29.0	5.0	-3.5
Profit share of GNP	%	10.4	9.1	9.2	8.3	7.6	8.6	9.7	10.6	10.0
Excluding FR Banks	%	10.1	8.9	8.9	8.0	7.3	8.4	9.5	10.5	9.8
Federal surpl./deficit	Bill. \$	-55.8	38.8	103.6	189.5	50.5	-240.0	-413.1	-403.4	-270.5
State & local surpl./def.		39.1	52.0	50.4	50.0	17.3	-3.2	-0.6	6.9	12.1
Ex. social ins. funds		38.0	50.3	48.7	47.9	14.0	-6.6	-4.0	3.3	8.4
Gross natl. saving rate	%	17.5	18.2	18.0	18.0	16.4	14.7	13.5	14.6	14.8
Net natl. saving rate		6.6	7.4	6.9	6.7	4.4	2.7	1.8	3.4	3.6
Prices and Costs										
GDP chn.-wt. price index	% change	1.5	1.1	1.6	2.2	2.4	1.4	1.6	1.8	1.4
Gross Domestic Purchases										
chn.-wt. price index		1.0	0.7	2.0	2.4	1.6	1.7	1.7	2.1	1.2
PCE chn.-wt. price index		1.3	0.9	2.1	2.3	1.6	1.8	1.5	2.1	1.2
Ex. food and energy		1.4	1.4	1.6	1.5	2.1	1.6	1.0	1.7	1.5
CPI		1.9	1.5	2.6	3.4	1.8	2.2	1.9	2.8	1.5
Ex. food and energy		2.2	2.3	2.0	2.6	2.7	2.0	1.2	2.3	2.0
ECI, hourly compensation ³		3.4	3.5	3.4	4.4	4.2	3.2	4.0	4.0	4.2
Nonfarm business sector										
Output per hour		2.0	2.8	3.2	2.1	2.9	4.3	5.4	2.2	2.0
Compensation per Hour		4.0	5.7	4.9	6.5	3.8	1.8	4.5	4.3	4.1
Unit labor cost		2.0	2.7	1.6	4.3	0.8	-2.4	-0.9	2.0	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.

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

June 23, 2004

Item	Units	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2
Expenditures											
Nominal GDP	Bill. \$	10024.8	10088.2	10096.2	10193.9	10329.3	10428.3	10542.0	10623.7	10735.8	10846.7
Real GDP	Bill. Ch. \$	9882.2	9866.3	9834.6	9883.6	9997.9	10045.1	10128.4	10160.8	10210.4	10288.3
Real GDP	% change	-0.2	-0.6	-1.3	2.0	4.7	1.9	3.4	1.3	2.0	3.1
Gross domestic purchases		-0.7	-0.4	-0.8	2.4	5.2	3.1	3.4	2.7	1.1	4.3
Final sales		1.4	0.7	-0.7	3.2	2.6	1.3	1.8	1.7	2.7	3.3
Priv. dom. final purchases		-0.1	-0.0	0.5	2.8	2.9	2.2	1.7	2.2	2.3	3.8
Personal cons. expenditures		0.5	2.3	1.9	6.2	4.1	2.6	2.0	2.2	2.5	3.3
Durables		1.7	9.8	0.7	27.3	1.6	0.5	5.0	0.3	0.5	17.7
Nondurables		0.4	-1.1	2.9	4.7	6.1	0.4	0.2	4.6	5.7	1.2
Services		0.3	2.4	1.6	2.8	3.8	4.1	2.2	1.5	1.5	1.7
Business fixed investment		-4.5	-13.6	-8.4	-14.0	-7.0	-3.0	-1.1	-0.1	-0.6	7.0
Equipment & Software		-4.0	-16.4	-12.2	-4.1	-0.2	1.2	3.7	1.7	0.5	8.0
Nonres. structures		-5.9	-5.6	2.2	-35.3	-23.9	-14.5	-14.6	-5.6	-4.0	3.9
Residential structures		2.6	3.7	3.1	-2.5	8.7	8.9	4.2	6.8	4.5	4.5
Exports		-4.5	-13.4	-17.7	-9.8	4.4	8.7	4.3	-3.7	-2.0	-1.1
Imports		-6.2	-8.5	-10.8	-3.8	8.4	17.1	4.1	8.2	-6.8	9.1
Gov't. cons. & investment		5.8	5.8	-4.1	7.4	4.6	4.0	2.5	7.1	-0.4	7.4
Federal		8.9	6.7	0.0	9.9	8.4	10.5	3.9	18.2	-0.2	23.5
Defense		7.7	2.6	2.4	14.2	8.2	9.5	4.5	22.1	-5.6	41.9
State & local		4.3	5.3	-6.1	6.1	2.7	0.7	1.7	1.5	-0.5	-0.8
Change in bus. inventories	Bill. Ch. \$	4.3	-28.8	-44.0	-75.5	-23.5	-8.0	32.8	21.5	1.6	-4.5
Nonfarm		-2.1	-26.9	-45.8	-70.3	-28.6	4.2	36.0	25.4	0.3	-2.4
Net exports		-385.9	-391.7	-401.3	-413.4	-431.2	-467.6	-471.9	-511.5	-490.0	-526.0
Nominal GDP	% change	2.9	2.6	0.3	3.9	5.4	3.9	4.4	3.1	4.3	4.2
GDP Gap ¹	%	-0.9	0.0	1.2	1.5	1.2	1.6	1.6	2.1	2.6	2.8
Employment and Production											
Nonfarm payroll employment	Millions	132.5	132.2	131.8	130.9	130.4	130.4	130.3	130.2	130.0	129.9
Unemployment rate	%	4.2	4.4	4.8	5.6	5.7	5.8	5.7	5.9	5.8	6.1
Industrial prod. index	% change	-6.3	-5.0	-5.2	-4.5	1.9	4.2	1.2	-1.9	0.9	-4.0
Capacity util. rate - mfg.		77.5	76.0	74.6	73.5	73.7	74.1	74.2	73.5	73.5	72.7
Housing starts	Millions	1.61	1.63	1.60	1.57	1.72	1.68	1.70	1.74	1.74	1.75
Light motor vehicle sales		17.07	16.70	16.18	18.54	16.47	16.52	17.56	16.62	15.96	16.37
North Amer. produced		14.17	13.65	13.20	15.15	13.17	13.24	14.22	13.36	12.60	13.06
Other		2.90	3.06	2.98	3.39	3.30	3.28	3.34	3.27	3.36	3.31
Income and Saving											
Nominal GNP	Bill. \$	10052.1	10115.5	10107.8	10268.3	10351.3	10435.9	10560.5	10661.6	10763.7	10880.0
Nominal GNP	% change	1.8	2.5	-0.3	6.5	3.3	3.3	4.9	3.9	3.9	4.4
Nominal personal income		4.6	1.2	1.7	2.0	1.5	5.0	1.4	1.7	3.0	4.4
Real disposable income		-0.3	-1.4	12.2	-4.4	10.6	4.1	-0.9	0.6	2.4	4.9
Personal saving rate	%	1.9	1.1	2.8	1.0	2.5	2.8	2.1	1.8	1.9	2.3
Corp. profits, IVA & CCAdj.	% change	-18.0	-3.8	-17.4	114.5	7.9	10.3	-0.9	16.5	-3.3	48.1
Profit share of GNP		7.5	7.4	7.1	8.4	8.5	8.6	8.5	8.8	8.6	9.4
Excluding FR Banks		7.2	7.1	6.8	8.2	8.3	8.4	8.3	8.6	8.4	9.2
Federal surpl./deficit	Bill. \$	156.1	128.9	-80.1	-2.8	-188.8	-232.0	-242.9	-296.3	-320.4	-424.7
State & local surpl./def.		36.1	24.6	11.6	-3.0	-7.4	-11.9	6.8	-0.4	-40.6	-14.7
Ex. social ins. funds		33.1	21.3	8.1	-6.6	-10.8	-15.3	3.4	-3.8	-44.0	-18.1
Gross natl. saving rate	%	17.1	16.3	15.9	16.1	15.3	15.1	14.4	13.8	12.9	13.2
Net natl. saving rate		5.6	4.4	3.3	4.4	3.5	3.2	2.5	1.8	0.9	1.4
Prices and Costs											
GDP chn.-wt. price index	% change	3.2	3.2	1.6	1.6	1.1	1.5	1.5	1.7	2.3	1.1
Gross Domestic Purchases											
chn.-wt. price index		2.6	2.3	1.0	0.5	1.0	2.4	1.6	1.7	3.4	0.4
PCE chn.-wt. price index		3.2	2.5	0.5	0.4	0.7	2.9	2.0	1.7	2.8	0.5
Ex. food and energy		2.8	1.9	1.3	2.5	1.0	1.9	2.0	1.5	0.9	0.8
CPI		3.7	3.2	1.1	-0.7	1.4	3.4	2.2	2.0	3.8	0.7
Ex. food and energy		2.9	2.6	2.8	2.4	2.1	2.3	2.1	1.7	1.3	1.0
ECI, hourly compensation ²		4.3	4.0	3.9	4.4	3.6	4.4	2.5	3.3	5.5	3.4
Nonfarm business sector											
Output per hour		-0.1	3.1	1.6	7.0	9.8	0.7	4.5	2.3	3.4	6.2
Compensation per hour		5.6	2.4	3.0	4.0	1.2	2.3	1.3	2.2	4.0	4.9
Unit labor cost		5.7	-0.7	1.3	-2.8	-7.8	1.6	-3.1	-0.1	0.6	-1.3

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

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

June 23, 2004

Item	Units	Projected									
		2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2	2005 Q3	2005 Q4
EXPENDITURES											
Nominal GDP	Bill. \$	11107.0	11262.0	11460.7	11666.7	11846.2	12012.2	12169.1	12316.7	12465.1	12613.3
Real GDP	Bill. Ch. \$	10493.1	10600.1	10716.0	10838.9	10976.1	11107.4	11209.4	11309.1	11408.8	11506.8
Real GDP	% change	8.2	4.1	4.4	4.7	5.2	4.9	3.7	3.6	3.6	3.5
Gross domestic purchases		7.0	4.3	4.9	4.5	5.4	5.3	4.1	3.4	3.8	3.9
Final sales		8.3	3.4	3.7	5.3	4.4	4.2	2.5	4.4	3.8	3.6
Priv. dom. final purchases		8.4	4.4	4.4	5.6	5.2	5.2	3.1	4.6	4.5	4.3
Personal cons. expenditures		6.9	3.2	4.0	3.4	4.6	4.5	4.1	3.9	3.7	3.6
Durables		28.0	0.7	-4.0	9.1	7.4	7.7	6.9	7.6	7.5	7.2
Nondurables		7.3	5.4	7.0	0.7	5.0	5.2	5.1	4.9	4.7	4.6
Services		2.8	2.8	4.2	3.7	3.9	3.5	3.1	2.8	2.5	2.4
Business fixed investment		12.8	10.9	6.7	14.2	14.1	17.1	0.1	12.2	11.9	12.1
Equipment & Software		17.6	14.9	10.2	17.3	17.4	20.9	-1.1	13.9	13.3	13.3
Nonres. structures		-1.8	-1.4	-4.4	3.9	3.0	4.1	5.0	6.2	6.9	7.8
Residential structures		21.9	7.9	4.5	18.8	-2.7	-7.0	-3.6	-1.5	-0.9	-1.4
Exports		9.9	20.5	7.4	7.4	9.7	10.8	6.8	8.3	7.9	9.0
Imports		0.8	16.4	10.2	5.6	9.8	11.7	8.2	5.5	8.3	10.3
Gov't. cons. & investment		1.8	-0.1	3.5	3.0	2.0	1.8	2.0	2.2	2.2	2.4
Federal		1.2	0.7	9.1	3.1	2.7	1.8	1.6	1.8	1.6	1.8
Defense		-1.3	3.0	13.4	4.2	1.5	1.1	1.3	1.5	1.2	1.6
State & local		2.1	-0.5	0.2	2.9	1.5	1.8	2.3	2.4	2.6	2.8
Change in bus. inventories	Bill. Ch. \$	-9.1	9.0	28.4	11.7	31.2	50.1	83.9	63.0	56.8	54.3
Nonfarm		-5.9	10.0	32.6	13.4	31.4	49.5	83.0	61.9	55.7	53.2
Net exports		-505.2	-515.2	-534.9	-537.3	-550.3	-568.3	-583.5	-583.6	-596.4	-614.9
Nominal GDP	% change	10.0	5.7	7.2	7.4	6.3	5.7	5.3	4.9	4.9	4.8
GDP Gap ¹	%	1.8	1.7	1.5	1.2	0.8	0.5	0.5	0.5	0.4	0.5
EMPLOYMENT AND PRODUCTION											
Nonfarm payroll employment	Millions	129.8	130.0	130.4	131.2	132.2	133.1	133.8	134.4	135.0	135.6
Unemployment rate	%	6.1	5.9	5.6	5.6	5.4	5.3	5.2	5.2	5.2	5.2
Industrial prod. index	% change	3.8	5.6	6.7	8.0	7.1	6.5	4.4	4.2	4.4	4.1
Capacity util. rate - mfg.	%	73.2	74.1	75.1	76.3	77.5	78.5	79.0	79.5	79.9	80.4
Housing starts	Millions	1.88	2.04	1.94	1.97	1.90	1.88	1.85	1.84	1.84	1.83
Light motor vehicle sales		17.42	16.84	16.34	16.86	17.30	17.38	17.38	17.51	17.65	17.81
North Amer. produced		14.07	13.64	13.11	13.41	13.84	13.90	13.91	14.02	14.14	14.28
Other		3.36	3.21	3.23	3.45	3.46	3.48	3.47	3.49	3.51	3.53
INCOME AND SAVING											
Nominal GNP	Bill. \$	11144.8	11337.9	11523.3	11734.7	11901.0	12060.0	12209.0	12341.1	12477.9	12609.6
Nominal GNP	% change	10.1	7.1	6.7	7.5	5.8	5.5	5.0	4.4	4.5	4.3
Nominal personal income		4.9	5.5	6.1	7.3	7.1	6.5	6.5	5.7	5.8	5.7
Real disposable income		6.8	1.2	5.0	4.1	4.7	4.8	4.5	4.1	4.2	4.0
Personal saving rate	%	2.4	1.9	2.2	2.4	2.4	2.5	2.6	2.7	2.8	2.9
Corp. profits, IVA & CCAdj.	% change	46.0	32.3	7.5	10.6	1.0	1.1	-2.1	-4.2	-3.9	-3.9
Profit share of GNP	%	10.1	10.6	10.7	10.7	10.6	10.5	10.3	10.1	9.9	9.7
Excluding FR Banks		9.9	10.5	10.5	10.6	10.4	10.3	10.1	9.9	9.7	9.5
Federal surpl./deficit	Bill. \$	-494.9	-412.2	-442.1	-419.0	-397.7	-354.6	-309.5	-267.9	-251.3	-253.4
State & local surpl./def.		13.1	39.9	23.5	-7.4	3.5	7.9	10.5	12.0	11.6	14.5
Ex. social ins. funds		9.6	36.4	19.9	-11.0	-0.1	4.2	6.8	8.3	7.9	10.8
Gross natl. saving rate	%	13.3	14.4	14.3	14.5	14.7	14.8	14.8	14.8	14.8	14.8
Net natl. saving rate		1.8	3.0	3.1	3.4	3.5	3.7	3.6	3.6	3.5	3.5
PRICES AND COSTS											
GDP chn.-wt. price index	% change	1.6	1.5	2.7	2.6	1.1	0.8	1.5	1.3	1.3	1.3
Gross Domestic Purchases											
chn.-wt. price index		1.8	1.3	3.3	2.8	1.4	1.0	1.4	1.1	1.2	1.2
PCE chn.-wt. price index		1.8	1.0	3.0	3.0	1.6	1.0	1.1	1.2	1.3	1.3
Ex. food and energy		1.0	1.2	1.7	1.6	1.7	1.6	1.6	1.5	1.4	1.4
CPI		2.4	0.7	3.5	4.5	2.0	1.0	1.3	1.5	1.7	1.7
Ex. food and energy		1.5	0.8	1.9	3.1	2.2	2.0	2.0	2.0	2.0	2.0
ECI, hourly compensation ²		4.4	3.1	4.3	3.8	3.9	4.0	4.1	4.2	4.2	4.2
Nonfarm business sector											
Output per hour		9.5	2.5	3.7	2.4	1.4	1.5	1.6	2.2	2.2	2.2
Compensation per hour		4.7	4.2	4.6	4.4	4.0	4.0	4.0	4.1	4.1	4.1
Unit labor cost		-4.3	1.7	0.9	2.0	2.6	2.5	2.3	1.9	1.9	1.9

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

CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

Item	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1	2003 Q2	2003 Q3	01Q4/ 00Q4	02Q4/ 01Q4	03Q4/ 02Q4
Real GDP	-1.3	2.0	4.7	1.9	3.4	1.3	2.0	3.1	8.2	-0.0	2.8	4.3
Gross dom. purchases	-0.9	2.5	5.4	3.2	3.5	2.8	1.2	4.4	7.4	0.1	3.7	4.3
Final sales	-0.8	3.2	2.7	1.3	1.8	1.7	2.7	3.3	8.3	1.1	1.9	4.4
Priv. dom. final purchases	0.4	2.4	2.5	1.9	1.5	1.9	1.9	3.3	7.2	0.7	1.9	4.0
Personal cons. expenditures	1.3	4.2	2.9	1.8	1.4	1.6	1.8	2.3	4.9	1.8	1.9	2.8
Durables	0.1	2.1	0.1	0.0	0.4	0.0	0.0	1.4	2.2	0.8	0.2	0.9
Nondurables	0.6	0.9	1.2	0.1	0.0	0.9	1.1	0.3	1.5	0.3	0.6	1.0
Services	0.6	1.2	1.6	1.7	0.9	0.7	0.6	0.7	1.2	0.7	1.2	0.9
Business fixed investment	-1.0	-1.7	-0.8	-0.3	-0.1	-0.0	-0.1	0.7	1.3	-1.3	-0.3	0.7
Equipment & Software	-1.1	-0.4	-0.0	0.1	0.3	0.1	0.0	0.6	1.3	-0.8	0.1	0.8
Nonres. structures	0.1	-1.4	-0.8	-0.4	-0.4	-0.1	-0.1	0.1	-0.0	-0.4	-0.4	-0.0
Residential structures	0.1	-0.1	0.4	0.4	0.2	0.3	0.2	0.2	1.1	0.1	0.3	0.5
Net exports	-0.4	-0.5	-0.7	-1.3	-0.2	-1.5	0.8	-1.3	0.8	-0.2	-0.9	-0.0
Exports	-2.0	-1.0	0.4	0.8	0.4	-0.4	-0.2	-0.1	0.9	-1.3	0.3	0.6
Imports	1.6	0.5	-1.1	-2.1	-0.6	-1.1	1.0	-1.2	-0.1	1.1	-1.2	-0.6
Government cons. & invest.	-0.7	1.3	0.9	0.7	0.5	1.3	-0.1	1.4	0.3	0.6	0.8	0.4
Federal	0.0	0.6	0.5	0.6	0.3	1.1	0.0	1.5	0.1	0.4	0.6	0.4
Defense	0.1	0.5	0.3	0.4	0.2	0.9	-0.3	1.6	-0.1	0.2	0.4	0.3
Nondefense	-0.1	0.0	0.2	0.3	0.1	0.3	0.2	-0.1	0.2	0.1	0.2	0.0
State and local	-0.7	0.7	0.3	0.1	0.2	0.2	-0.1	-0.1	0.3	0.3	0.2	0.0
Change in bus. inventories	-0.5	-1.2	2.0	0.6	1.6	-0.4	-0.7	-0.2	-0.1	-1.2	0.9	-0.1
Nonfarm	-0.7	-0.9	1.6	1.3	1.3	-0.4	-0.9	-0.1	-0.1	-1.1	0.9	-0.1
Farm	0.1	-0.3	0.4	-0.6	0.3	-0.0	0.2	-0.1	-0.0	-0.1	0.0	0.1

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

CONTRIBUTIONS TO GROWTH IN REAL GROSS DOMESTIC PRODUCT AND RELATED ITEMS

Item	2003				2004				Projected				2005				
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	4.1	4.4	4.7	5.2	4.9	3.7	3.6	3.6	3.6	3.6	3.6	3.6	3.5	4.3	4.8	4.8	3.6
Gross dom. purchases	4.5	5.1	4.7	5.6	5.5	4.3	3.6	4.0	4.1	4.3	4.3	4.0	4.1	4.3	5.3	5.3	4.0
Final sales	3.4	3.7	5.3	4.4	4.2	2.5	4.3	3.8	3.6	4.4	4.4	3.8	3.6	4.4	4.4	4.4	3.6
Priv. dom. final purchases	3.8	3.7	4.8	4.5	4.5	2.7	3.9	3.8	3.7	4.0	4.0	3.8	3.7	4.0	4.4	4.4	3.6
Personal cons. expenditures	2.3	2.8	2.4	3.3	3.1	2.9	2.7	2.6	2.5	2.8	2.8	2.6	2.5	2.8	2.9	2.9	2.7
Durables	0.1	-0.3	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.9	0.9	0.6	0.6	0.9	0.9	0.9	0.6
Nondurables	1.1	1.4	0.2	1.0	1.0	1.0	1.0	0.9	0.9	1.0	1.0	0.9	0.9	1.0	0.9	0.9	1.0
Services	1.2	1.8	1.5	1.6	1.5	1.3	1.2	1.1	1.0	1.6	1.6	1.1	1.0	0.9	1.6	1.6	1.1
Business fixed investment	1.1	0.7	1.4	1.4	1.7	0.0	1.3	1.3	1.3	0.7	0.7	1.3	1.3	0.7	1.3	1.3	1.0
Equipment & Software	1.1	0.8	1.3	1.3	1.6	-0.1	1.1	1.1	1.1	0.8	0.8	1.3	1.3	0.8	1.3	1.3	0.8
Nonres. structures	-0.0	-0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	-0.0	-0.0	0.2	0.2	-0.0	0.0	0.0	0.1
Residential structures	0.4	0.2	0.9	-0.1	-0.4	-0.2	-0.1	-0.0	-0.1	0.5	0.5	-0.0	-0.1	0.5	0.2	0.2	-0.1
Net exports	-0.3	-0.7	-0.1	-0.5	-0.6	-0.5	0.0	-0.4	-0.6	-0.0	-0.0	-0.4	-0.6	-0.0	-0.5	-0.5	-0.4
Exports	1.8	0.7	0.7	1.0	1.1	0.7	0.8	0.8	0.9	0.6	0.6	0.8	0.9	0.6	0.9	0.9	0.8
Imports	-2.1	-1.4	-0.8	-1.4	-1.7	-1.2	-0.8	-1.2	-1.5	-0.6	-0.6	-1.2	-1.5	-0.6	-1.3	-1.3	-1.2
Government cons. & invest.	-0.0	0.6	0.6	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.4
Federal	0.1	0.6	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.1
Defense	0.1	0.6	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.2	0.2	0.1
Nondefense	-0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1
State and local	-0.1	0.0	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.2	0.3	0.3	0.3	0.0	0.2	0.2	0.3
Change in bus. inventories	0.7	0.8	-0.6	0.7	0.7	1.2	-0.7	-0.2	-0.1	0.7	1.2	-0.2	-0.1	-0.1	0.4	0.4	0.0
Nonfarm	0.6	0.8	-0.7	0.6	0.6	1.2	-0.7	-0.2	-0.1	0.6	1.2	-0.2	-0.1	-0.1	0.4	0.4	0.0
Farm	0.1	-0.1	0.1	0.1	0.0	0.0	0.0	-0.0	-0.0	0.1	0.0	-0.0	-0.0	0.1	0.0	0.0	0.0

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

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

Item	Fiscal year				2003				2004				2005					
	2002 ^a		2003 ^a		2004	2005	Q1 ^a	Q2 ^a	Q3 ^a	Q4 ^a	Q1 ^a	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	2002 ^a	2003 ^a	2003 ^a	2004	2005	Q1 ^a	Q2 ^a	Q3 ^a	Q4 ^a	Q1 ^a	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Unified budget	Not seasonally adjusted																	
Receipts ¹	1853	1782	1863	2067	2067	398	528	429	441	410	547	465	469	451	630	517	516	
Outlays ¹	2011	2158	2290	2411	2411	543	544	534	569	580	573	567	607	605	598	601	623	
Surplus/deficit ¹	-158	-375	-428	-344	-344	-145	-17	-105	-129	-171	-26	-102	-137	-154	32	-84	-107	
On-budget	-317	-536	-589	-531	-531	-169	-91	-113	-178	-193	-102	-115	-182	-195	-51	-103	-155	
Off-budget	160	161	161	187	187	24	75	9	50	23	76	14	45	40	83	19	49	
Means of financing																		
Borrowing	221	374	431	362	362	64	106	108	119	136	44	133	125	143	7	87	83	
Cash decrease	-17	26	-3	-7	-7	20	-17	-5	2	12	-22	5	4	4	-30	15	15	
Other ²	-46	-24	-1	-11	-11	62	-73	2	8	23	4	-36	8	7	-9	-17	9	
Cash operating balance, end of period	61	35	38	45	45	13	30	35	33	21	43	38	34	30	60	45	30	
NIPA federal sector	Seasonally adjusted annual rates																	
Receipts	1895	1844	1918	2157	2157	1864	1864	1789	1887	1884	1926	1973	2044	2146	2200	2240	2264	
Expenditures	2062	2228	2335	2454	2454	2184	2289	2284	2299	2326	2345	2371	2399	2455	2469	2491	2518	
Consumption expenditures	573	649	699	735	735	636	669	672	675	697	711	715	720	735	740	744	750	
Defense	370	426	468	491	491	409	448	444	450	465	476	479	482	491	494	497	500	
Nondefense	202	223	232	244	244	227	221	229	225	232	235	236	238	244	246	248	250	
Other spending	1489	1579	1636	1719	1719	1548	1620	1612	1625	1629	1634	1656	1679	1720	1729	1747	1769	
Current account surplus	-167	-384	-418	-296	-296	-320	-425	-495	-412	-441	-419	-398	-355	-310	-268	-252	-254	
Gross investment	87	92	103	106	106	87	96	97	97	106	104	105	105	106	107	107	108	
Gross saving less gross investment ³	-165	-386	-428	-307	-307	-318	-430	-501	-417	-454	-430	-409	-366	-320	-279	-262	-264	
Fiscal indicators⁴																		
High-employment (HEB) surplus/deficit	-114	-311	-382	-292	-292	-239	-342	-435	-353	-405	-391	-379	-347	-306	-266	-250	-251	
Change in HEB, percent of potential GDP	1.9	1.7	0.5	-0.9	-0.9	0.1	0.9	0.8	-0.8	0.4	-0.2	-0.1	-0.3	-0.4	-0.4	-0.2	-0.0	
Fiscal impetus (FI) percent of GDP	1.0	1.2	0.9	-0.2	-0.2	0.1	0.5	0.4	0.3	0.3	0.1	0.1	0.1	-0.4	0.0	0.0	0.0	

1. OMB's February 2004 baseline surplus estimates are -\$527 billion in FY 2004 and -\$393 billion in FY 2005 and surplus estimates under enactment of its proposed policies (which do not include additional funding for Iraq) are -\$521 billion and -\$364 billion, respectively. CBO's March 2004 baseline surplus estimates are -\$477 billion in FY 2004 and -\$363 billion in FY 2005. Budget receipts, outlays, and surplus/deficit include corresponding social security (OASDI) categories. The OASDI surplus and the Postal Service surplus are excluded from the on-budget surplus and shown separately as off-budget, as classified under current law.

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

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

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

a--Actual

Strictly Confidential (FR) **Change in Debt of the Domestic Nonfinancial Sectors** **June 23, 2004**
Class II FOMC **(Percent)**

Period ¹	Total	Federal government	Nonfederal					Memo: Nominal GDP	
			Total	Households		Business	State and local governments		
				Total	Home mortgages				Consumer credit
<i>Year</i>									
1998	6.8	-1.4	9.6	7.9	8.2	7.3	12.2	6.3	5.7
1999	6.3	-1.9	8.8	8.2	9.1	7.8	10.6	3.4	6.3
2000	4.9	-8.0	8.4	8.8	8.4	10.7	9.4	1.3	4.6
2001	6.2	-0.2	7.7	9.0	9.9	8.0	6.1	8.9	2.4
2002	7.0	7.6	6.8	9.7	12.0	4.4	2.9	11.1	4.2
2003	8.2	10.9	7.6	10.4	12.7	4.9	4.3	8.2	6.0
2004	7.8	10.8	7.1	9.3	10.7	5.8	4.7	5.4	6.7
2005	6.7	7.2	6.6	7.2	7.5	6.6	6.3	3.9	5.0
<i>Quarter</i>									
2003:1	6.9	4.5	7.5	10.8	13.4	4.3	3.8	5.7	4.3
2	11.3	20.4	9.3	11.7	13.6	6.2	5.9	12.4	4.2
3	7.2	8.2	7.0	10.2	12.0	6.0	3.2	6.1	10.0
4	6.4	9.0	5.9	7.3	9.5	2.8	3.9	7.6	5.7
2004:1	8.6	11.6	8.0	10.9	12.5	6.1	4.1	9.6	7.2
2	7.3	11.5	6.4	9.2	10.9	4.7	3.7	2.4	7.4
3	7.1	9.6	6.5	8.5	9.5	6.0	4.6	3.9	6.3
4	7.2	9.0	6.8	7.6	8.3	6.1	6.0	5.3	5.7
2005:1	7.5	11.1	6.7	7.3	7.7	6.4	6.4	4.3	5.3
2	6.6	7.2	6.4	7.0	7.4	6.5	6.1	3.8	4.9
3	6.0	4.8	6.3	6.9	7.2	6.6	6.0	3.7	4.9
4	6.0	4.8	6.2	6.7	6.9	6.5	6.2	3.5	4.8

Note. Quarterly data are at seasonally adjusted annual rates.

1. Data after 2003: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) **Flow of Funds Projections: Highlights** **June 23, 2004**
Class II FOMIC **(Billions of dollars at seasonally adjusted annual rates except as noted)**

Category	2002				2003				2004				2005			
	2002	2003	2004	2005	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
<i>Net funds raised by domestic nonfinancial sectors</i>																
1 Total	1297.9	1628.1	1627.4	1520.0	1499.3	1345.4	1823.5	1570.6	1559.2	1556.2	1668.8	1541.3	1429.6	1440.4		
2 Net equity issuance	-41.6	-57.3	-109.3	-82.8	-44.9	-67.0	-104.0	-98.0	-90.0	-145.0	-135.0	-65.0	-68.0	-63.0		
3 Net debt issuance	1339.5	1685.3	1736.6	1602.8	1544.2	1412.4	1927.5	1668.6	1649.2	1701.2	1803.8	1606.3	1497.6	1503.4		
<i>Borrowing sectors</i>																
Nonfinancial business																
4 Financing gap ¹	23.1	-56.5	-53.0	148.2	-99.9	-78.6	-76.2	-100.7	-52.8	17.7	99.7	132.7	167.3	193.1		
5 Net equity issuance	-41.6	-57.3	-109.3	-82.8	-44.9	-67.0	-104.0	-98.0	-90.0	-145.0	-135.0	-65.0	-68.0	-63.0		
6 Credit market borrowing	197.8	302.2	347.2	492.2	231.1	282.9	303.5	276.4	348.6	460.2	499.4	483.9	481.1	504.5		
Households																
7 Net borrowing ²	740.3	869.5	867.6	726.9	903.9	659.9	1008.2	875.5	827.1	759.4	738.1	727.0	727.3	715.0		
8 Home mortgages	638.4	756.1	719.7	558.7	764.3	625.6	840.2	756.0	677.2	605.6	575.3	559.9	556.0	543.5		
9 Consumer credit	81.4	94.8	118.6	143.0	118.9	56.6	123.4	96.9	126.1	128.2	136.9	142.1	146.3	146.7		
10 Debt/DPI (percent) ³	102.1	107.5	111.2	113.7	108.0	109.9	110.3	111.1	111.8	112.5	113.0	113.5	114.0	114.4		
State and local governments																
11 Net borrowing	143.9	117.6	84.4	63.8	91.6	116.2	149.7	38.3	62.8	86.8	70.8	62.8	62.8	58.8		
12 Current surplus ⁴	170.1	178.6	160.2	170.6	199.3	219.6	174.4	145.6	157.6	163.1	166.9	169.7	170.8	175.0		
Federal government																
13 Net borrowing	257.5	396.0	437.5	319.9	317.5	353.4	466.0	478.5	410.7	394.9	495.5	332.6	226.5	225.1		
14 Net borrowing (n.s.a.)	257.5	396.0	437.5	319.9	107.6	118.6	135.9	43.7	132.9	125.1	143.2	7.2	86.8	82.7		
15 Unified deficit (n.s.a.)	230.6	394.7	436.1	313.7	104.5	128.7	170.8	26.5	101.7	137.1	154.5	-31.8	84.4	106.6		
<i>Depository institutions</i>																
16 Funds supplied	482.5	477.1	561.2	498.4	147.4	385.3	1096.2	296.5	446.5	405.4	591.5	442.4	536.5	423.2		
Memo (percentage of GDP)																
17 Domestic nonfinancial debt ⁵	189.8	195.1	197.2	200.4	195.4	196.2	196.7	197.1	197.6	198.3	199.4	200.4	201.2	201.8		
18 Domestic nonfinancial borrowing	12.8	15.3	14.8	12.9	13.9	12.5	16.8	14.3	13.9	14.2	14.8	13.0	12.0	11.9		
19 Federal government ⁶	2.5	3.6	3.7	2.6	2.9	3.1	4.1	4.1	3.5	3.3	4.1	2.7	1.8	1.8		
20 Nonfederal	10.3	11.7	11.1	10.4	11.0	9.4	12.8	10.2	10.5	10.9	10.8	10.3	10.2	10.1		

Note. Data after 2003: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.

n.s.a. Not seasonally adjusted.

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.

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International Developments

Strong demand from the United States and a buoyant high-tech sector continue to underpin the robust performance abroad, and, based on incoming data, we have marked up our estimates of average foreign growth for the first and second quarters of this year. Going forward, foreign economic activity is expected to decelerate, as growth in Asia, especially in China, settles to more sustainable rates. Relative to the previous Greenbook, the overall foreign growth outlook is about unchanged, with downward revisions to the euro area and emerging Asia about offsetting upward revisions to Japan, Canada, and Mexico. Foreign CPI inflation is estimated to have increased to nearly 3 percent in the second quarter, but we expect it to move back down over the forecast period as energy prices and non-fuel commodity prices fall.

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

Indicator	2003		2004	Projection		
	H1	H2	Q1	2004		2005
				Q2	H2	
Foreign output	.9	4.5	4.3	4.0	3.6	3.5
<i>April GB</i>	.9	4.5	3.9	3.9	3.6	3.5
Foreign CPI	2.0	2.1	2.5	2.9	2.3	2.1
<i>April GB</i>	2.0	2.1	2.5	2.2	2.1	2.0

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

Oil prices surged in May, as violence in Iraq and Saudi Arabia threatened supply and as world demand for oil remained strong. Since early June, this most recent run-up in spot oil prices has reversed substantially, following a promise by OPEC to increase oil production. In line with futures quotes, we project that oil prices, after peaking in the second quarter, will fall going forward, with the new path being roughly \$3 per barrel above that projected in the April Greenbook. Prices of non-fuel primary commodities are expected to follow a similar path.

The major currencies index of the nominal value of the dollar declined 1½ percent on balance over the intermeeting period, but this was partially offset by a dollar appreciation against several of our other important trading partners. As a result, the broad nominal index moved down only a little. However, primarily because of price developments in the United States and abroad, our projected path of the broad real dollar starts out in the third quarter at a somewhat higher level than anticipated in the April Greenbook. Going forward, we have lessened the projected depreciation of the broad real dollar, owing to changes in our assumptions about monetary policy, which call for relatively more tightening by the FOMC.

We now estimate that real exports of goods and services rose 7½ percent and that real imports moved up 10 percent in the first quarter, reflecting stronger March data than we had anticipated as well as upward revisions to January and February data. We project that growth of exports and imports will continue to be solid for the remainder of this year and for next year. Net exports are projected to subtract about ½ percentage point from GDP growth this year and slightly less next year. The current account deficit is projected to widen to \$740 billion by the fourth quarter of next year, nearly 6 percent of GDP.

Oil Prices

Oil prices were particularly volatile over the intermeeting period. After averaging \$36.70 per barrel in April, the spot price of West Texas Intermediate (WTI) surged to average more than \$40 per barrel in May and reached a peak of \$42.35 per barrel on June 1. This run-up in oil prices appeared to result from a market reaction to an upsurge in violence in Iraq and Saudi Arabia that occurred against a backdrop of surprisingly strong world oil demand and lean inventories. Sabotage of the oil infrastructure in Iraq has intermittently disrupted Iraqi oil exports. Attacks on foreign workers in Saudi Arabia have intensified concerns about the security of Saudi oil production. Additional supply concerns include continued ethnic unrest in Nigeria, ongoing political uncertainty in Venezuela, and a labor strike in Norway.

In response to higher oil prices, OPEC (excluding Iraq) increased crude oil production 700,000 barrels per day in May. Within OPEC, only Saudi Arabia and the United Arab Emirates are believed to have significant spare production capacity. Saudi Arabia, whose near-term production capacity is about 10 million barrels per day, indicated that it would produce 9 million barrels per day in June, an increase of about 500,000 barrels per day from May. Following these statements of intent to boost production, spot oil prices have reversed much of their recent run-up, with the spot price of WTI closing at about \$38 per barrel on June 22. The projected path of oil prices, in line with recent quotes from futures markets, calls for the spot price of WTI to decline to about \$37 per barrel by the fourth quarter of 2004 and to about \$34 per barrel by the fourth quarter of 2005. This path for WTI is about \$3 per barrel higher than was projected in the previous Greenbook.

International Financial Markets

The major currencies index of the exchange value of the dollar moved up during the first half of May in response to favorable U.S. economic data releases (especially employment) and to a shift in market expectations concerning the timing and pace and of Fed tightening. Subsequently, the dollar more than reversed these gains on other U.S. data releases, including the U.S. May CPI report (which was more benign than some market participants reportedly had

anticipated), as well as on stronger-than-expected economic performance and monetary policy tightening in some foreign industrial countries. On balance, the major currencies index declined 1½ percent over the intermeeting period.

The dollar depreciated, on net, about 2½ and nearly 4 percent, respectively, against sterling and the Swiss franc, in part because the Bank of England and the Swiss National Bank tightened policy. It also depreciated about 1½ percent against the euro, the yen, and the Canadian dollar.

The U.S. dollar appreciated against several Latin American currencies in early May as investors speculated that rising interest rates could adversely affect economic conditions in the region. The Mexican peso subsequently more than recouped its losses against the dollar, but the Brazilian *real* depreciated about 5 percent on net. With some of the Asian currencies also depreciating significantly, all told the intermeeting period saw a mild net increase of the dollar's trade-weighted exchange value against the currencies of our other important trading partners.

Over the forecast period, the broad real dollar is projected to start out in the third quarter at about 1 percent above the level we wrote down in the April Greenbook and then to depreciate just ½ percent through the end of next year. This represents a flatter path of the dollar relative to the last Greenbook, as the paths for future policy rates have been revised up more for the United States than abroad.

Foreign interest rates rose in May, in response to economic data releases and to U.S. rates, but fell back somewhat late in the intermeeting period after the release of the U.S. May CPI report. Long-term government bond yields rose about 35 basis points on net in Japan and Canada and about 20 basis points in the euro area and the United Kingdom. Short-term interest rates generally rose as well, especially in the United Kingdom, as the Bank of England twice tightened policy 25 basis points and market participants factored in further monetary policy tightening in coming months. With short-term yen rates unchanged, the yield curve steepened sharply in Japan.

Share price indexes in the major foreign economies slipped slightly on balance, with concerns about higher global interest rates outweighing generally encouraging news about economic activity. In Japan, share prices fell sharply in early May following statements by Chinese authorities of their intent to slow their economy, but subsequently recovered on favorable domestic economic data.

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

Foreign Industrial Countries

Growth in the foreign industrial countries eased to 2¾ percent in the first quarter but was slightly higher than in the April Greenbook. We estimate that growth in these countries edged up to a little more than 3 percent in the second quarter, as faster growth in Canada and the United Kingdom outweighed a moderation in Japan and the euro area. We expect growth to settle to a rate of just less than 3 percent over the remainder of the forecast period. After having picked up in the second quarter, largely because of higher oil prices, twelve-month headline inflation should ease back in most foreign industrial countries by next year, with the important exception of Japan.

Japanese real GDP posted a robust gain of more than 6 percent in the first quarter, with sizable contributions from most spending categories. The recent strength in consumption should diminish as saving rates begin to reverse their prior declines. Slowing in the pace of activity in emerging Asia should reduce the very rapid growth rates of exports that Japan has recorded recently. As a result of these factors, we project that growth will moderate over the forecast period. Twelve-month CPI inflation is projected to become positive by the end of this year for the first time since 1999. Nonetheless, inflationary pressures should remain weak over the forecast period, and we expect the Bank of Japan to maintain its quantitative easing policy.

In the euro area, real GDP grew at a faster-than-expected pace of 2¼ percent in the first quarter. We estimate that growth in the second quarter fell to 1½ percent, as export growth slowed from its unusually strong first-quarter pace and as domestic demand, especially in Germany, remained weak. Going forward, a firming of private spending should push up growth to nearly 2 percent. Higher oil and administered prices contributed to an increase in euro-area inflation in the second quarter. We now project that twelve-month inflation will remain above the ECB's 2 percent target through the beginning of next year, and, accordingly, the ECB will tighten policy sooner in 2005 than we previously anticipated.

In the United Kingdom, real GDP growth is estimated to have increased to slightly above 3 percent in the second quarter and is projected to fall back gradually to just above 2½ percent by the end of 2005, as consumption growth slows in response to an assumed deceleration of house prices. Weaker consumption should be somewhat offset by stimulative fiscal policy and some strengthening of exports. We assume that the Bank of England will continue its

gradual tightening of monetary policy and that this will be sufficient to keep inflation from moving above the 2 percent target rate.

Canadian real GDP grew nearly 2½ percent in the first quarter, as robust final domestic demand overcame a large drag from inventories. We estimate that growth rebounded to 4 percent in the second quarter, with domestic demand remaining strong. Growth should hover around 3½ percent for the remainder of the forecast period. The Bank of Canada is assumed to begin increasing policy rates by the end of this year, sooner than in the April Greenbook, and Canadian inflation is projected to remain within the 1-3 percent target range.

Other Countries

We now estimate that output in emerging Asia grew nearly 8 percent, on average, in the first quarter. With evidence that growth is slowing in China, and with the recent run-up in oil prices, we expect that activity in the region will moderate more in the near term than we had previously anticipated. Growth is projected to average a little more than 6 percent this year, about ¾ percentage point lower than forecast in the April Greenbook. We continue to project that growth in the region will slow next year to about 5¼ percent.

With investment growing at an unsustainable rate, Chinese authorities have recently taken measures to rein in the economy. Their actions have led to a deceleration in investment, imports, the money supply, and lending. Our forecast for China is consistent with a “soft landing,” with real GDP still increasing at an annual rate of 6¼ percent in the second half of this year and 7¼ percent next year. However, there is some risk of a “harder landing” as described at the end of this section. We maintain our working assumption that China will keep its current exchange rate arrangement in place through the forecast period.

In Korea, real GDP growth slowed considerably in the first quarter, to around 3 percent, as private consumption and investment declined. Indicators from the current quarter point to continued weakness in domestic demand, which is partly constrained by high consumer debt burdens. Accordingly, we have revised down somewhat the outlook for real output in Korea and now expect growth of around 5 percent over the forecast period.

In Latin America, recent economic growth has surprised on the upside. Mexican real GDP posted a robust gain of 5½ percent in the first quarter and, in light of continued strength of U.S. industrial output and incoming Mexican data, we have also revised up our estimate of second-quarter growth. Mexican growth should moderate to 4 percent next year, roughly in line with U.S. growth. The Brazilian economy grew nearly 7 percent in the first quarter, largely because of a rise in net exports. We project that Brazilian growth will come in at 3½ percent this

year, about 1 percentage point higher than forecast in the April Greenbook, before slowing a bit next year.

Consumer price inflation is estimated to have risen in the second quarter in some economies of emerging Asia, particularly China, Indonesia, and the Philippines. In the case of China, increases in food prices accounted for the bulk of the rise. We expect inflation in developing countries to climb to nearly 4 percent in the second half of this year before falling to about 3 percent next year, largely reflecting movements in oil and other primary commodity prices.

Prices of Internationally Traded Goods

Prices of imported core goods rose at an annual rate of 6½ percent in the first quarter, the highest rate of increase since the fourth quarter of 1988. Based on BLS data through May, our estimate is that prices of core goods imports rose at an annual rate of 4½ percent in the second quarter, about 1½ percentage points more than projected in the April Greenbook. The rise in core import prices so far this year has largely been driven by the direct effects of higher commodity prices, which have shown through to increased import prices of non-oil industrial supplies and foods. Prices for other categories of imports have registered much smaller increases. We project that core import prices will increase at an annual rate of about 3½ percent over the remainder of 2004 as the lagged effects of the run-up in commodity prices diminish. Next year, with subdued inflation abroad and small declines in prices for primary commodities, core import price inflation should moderate to less than 1 percent.

Prices of exported core goods increased at an annual rate of nearly 8 percent in the first quarter, largely reflecting increases in prices of foods (especially soybeans) and industrial supplies. Based on monthly data on trade prices through May, our estimate is that prices of core goods exports continued to rise at about the same pace in the second quarter. This estimate is about 2½ percentage points higher than the one in the April Greenbook, reflecting higher domestic prices of intermediate materials and agricultural products. We project that the rate of increase in core export prices over the forecast period will

slow sharply to about $\frac{3}{4}$ percent, as commodity prices fall and prices of intermediate materials decelerate.

Staff Projections of Selected Trade Prices

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

Trade category	2003		2004	Projection		
	H1	H2	Q1	2004		2005
				Q2	H2	
<i>Exports</i>						
Core goods	3.5	3.2	7.9	7.8	0.8	0.7
<i>Imports</i>						
Non-oil core goods	2.5	1.1	6.5	4.6	3.3	0.7
Oil (dollars per barrel)	26.42	27.74	30.91	34.14	33.82	31.57

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

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

Trade in Goods and Services

Although not sustaining the fourth quarter's red-hot pace of about 20 percent (a.r.), real exports of goods and services grew a solid $7\frac{1}{2}$ percent in the first quarter of this year. The increase was more than double what we reported in the April Greenbook, reflecting stronger-than-expected export data for March, as well as upward revisions to previously published data for January and February.

For the current quarter, we estimate that real exports of goods and services continued to grow at a rate of around $7\frac{1}{2}$ percent. A bit more than half this growth reflects solid gains in exports of core goods, albeit at a lower pace than in the first quarter, supported by strong growth abroad and the effects of past dollar depreciation. After contracting in the first quarter, exports of computers are estimated to have increased a bit. Semiconductors, on the other hand, appear to have grown more moderately than in the first quarter, based partly on the April trade data. Exports of services grew at an estimated $8\frac{1}{2}$ percent rate, more than twice as fast as in the first quarter. Although second-quarter growth of real exports of goods and services is lower than projected in the April Greenbook, our estimate for the first half of this year as a whole is about unchanged.

Over the remainder of the forecast period, growth in real exports of goods and services should continue to be fairly robust, with projected expansions of around 10 percent in the second half and 8 percent next year. Relative to the April Greenbook, we have marked down the projected growth rate of core goods exports about $1\frac{1}{4}$ percentage points on average, based largely on trade data

revisions that led us to re-assess the long-run level of exports implied by foreign activity and relative prices. Nevertheless, core goods exports still expand at an annual rate of 7 percent over the next year and a half, supported by solid foreign growth and ongoing effects of the dollar's earlier depreciation.

**Summary of Staff Projections
for Trade in Goods and Services**

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

Measure	2003		2004	Projection		
	H1	H2	Q1	2004		2005
				Q2	H2	
Real exports	-1.5	15.1	7.4	7.4	10.2	8.0
<i>April GB</i>	-1.5	15.1	2.7	11.2	11.7	9.1
Real imports	.9	8.3	10.2	5.6	10.8	8.1
<i>April GB</i>	.9	8.3	3.1	10.7	9.2	8.6

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

Expansion in real imports of goods and services also stepped down from its torrid pace of the fourth quarter; nevertheless, the 10 percent (a.r.) increase in the first quarter was considerably greater than we projected in the April Greenbook. As in the case of exports, imports for March generally came in higher than expected, and January and February data were revised up significantly.

In the current quarter, real imports of goods and services are projected to grow around 5½ percent, a pace about half that projected in the April Greenbook. Both the revision in import growth in the second quarter and the stepdown from the first quarter are driven by the Department of Commerce's recently introduced seasonal adjustment factors for oil imports, which tend to depress oil imports in the second quarter and boost them in the fourth quarter.¹ In this quarter, growth in imported core goods, supported by robust U.S. growth, appears to have picked up somewhat from the first quarter. We estimate that imports of services accelerated from a sluggish first quarter, expanding at an annual rate of around 9½ percent in the second quarter.

1. Previously, oil imports were adjusted for the number of days in a quarter, which resulted in only small differences between the seasonally and not seasonally adjusted series. The new procedure, which applies the Census X12 algorithm to the value of oil imports, has resulted in a series that shows greater quarter-to-quarter variation than the not seasonally adjusted series. Despite this effect, we understand that the Bureau of Economic Analysis intends to incorporate the new data into the National Income and Product Accounts beginning with the Final Q1 GDP release on June 25.

We look for real imports of goods and services to grow 11 percent in the second half of this year but then to decelerate, with an increase of 8 percent next year. Similarly, growth of core imports is projected to slow from 9½ percent to 8 percent over the same interval, reflecting the projected tempering of growth in the United States. This effect is partially offset by a lessening of the drag coming from import prices. Imports of computers and semiconductors are also expected to decelerate in 2005, following the scheduled expiration of the partial-expensing tax provision. Changes from the April Greenbook in the quarterly contour of the growth path for total imports are heavily influenced by the introduction of the new seasonal factors for oil imports.

Alternative Simulation

In our baseline forecast, we assume that the authorities in China will succeed in achieving a “soft landing” for economic activity. However, there is some risk that the investment boom that has been the main catalyst for the recent growth spurt will be succeeded by an unexpectedly sharp slowdown. Accordingly, in our alternative simulation we used the FRB/Global model to examine the effects of a “hard landing” in China. Such a hard-landing scenario includes an autonomous shock to Chinese demand that would depress private spending by 6 percent of baseline GDP in the absence of endogenous adjustment. The shock is assumed to occur in 2004:Q3 and is phased in over four quarters. In addition, this scenario includes an autonomous decline in demand of 1 percent of baseline GDP in other developing Asian economies.

This adverse demand shock lowers Chinese growth about 11 percentage points in the second half of 2004 and about 8 percentage points in 2005, relative to baseline. The large multiplier effect associated with the autonomous shock reflects the assumption that China maintains an exchange rate peg to the U.S. dollar and does not engage in countercyclical monetary policy. The shock depresses U.S. real net exports, lowering U.S. real GDP growth in 2005 about 0.2 percentage point relative to baseline. The shock also reduces U.S. core PCE inflation 0.2 percentage point relative to baseline in 2005, mainly because the fall in Chinese demand lowers worldwide energy and commodity prices.

**Alternative Simulation:
Hard Landing in China**
(Percent change from previous period, annual rate)

Indicator and simulation	2004	2005	
	H2	H1	H2
<i>U.S. real GDP</i>			
Baseline	5.0	3.7	3.5
Demand shock in China	5.0	3.6	3.3
<i>U.S. PCE prices excl. food and energy</i>			
Baseline	1.7	1.5	1.4
Demand shock in China	1.7	1.3	1.2

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.

June 23, 2004

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

Measure and country	1997	1998	1999	2000	2001	2002	2003	Projected 2004	Projected 2005
REAL GDP (1)									

Total foreign	4.2	1.5	5.0	4.3	0.3	2.9	2.7	3.9	3.5
Industrial Countries	3.4	2.7	4.4	3.6	0.6	2.6	1.7	3.0	2.8
Of which:									
Canada	4.4	4.4	5.9	4.1	1.4	3.8	1.7	3.4	3.5
Japan	0.4	-1.2	0.4	3.9	-2.2	1.8	3.5	3.9	2.4
United Kingdom	3.4	2.8	3.3	2.9	1.9	1.9	2.7	2.9	2.7
Euro Area (2)	3.2	2.0	3.9	2.7	0.7	1.1	0.7	1.8	1.9
Germany	1.7	0.7	3.4	1.9	0.5	0.5	0.1	1.2	1.5
Developing Countries	5.4	-0.3	6.0	5.2	-0.2	3.4	4.1	5.3	4.4
Asia	5.0	-2.2	8.3	6.0	1.0	5.8	6.0	6.1	5.2
Korea	3.1	-5.4	11.4	4.5	4.7	7.7	4.1	4.6	5.0
China	8.7	9.5	4.1	8.0	7.5	8.0	9.9	8.8	7.3
Latin America	6.2	1.2	4.2	4.4	-1.3	1.4	2.2	4.7	3.8
Mexico	6.8	2.9	5.4	4.8	-1.2	1.9	2.0	4.9	4.1
Brazil	2.5	-1.6	3.4	3.8	-0.8	3.8	-0.1	3.5	3.0
CONSUMER PRICES (3)									

Industrial Countries	1.5	0.9	1.1	1.7	0.9	2.1	1.3	1.5	1.5
of which:									
Canada	1.0	1.1	2.4	3.1	1.1	3.8	1.7	1.8	1.7
Japan	2.1	0.7	-1.1	-1.2	-1.3	-0.5	-0.4	0.1	0.3
United Kingdom (4)	1.7	1.4	1.2	1.0	1.0	1.6	1.3	1.3	1.8
Euro Area (2)	1.5	0.8	1.5	2.5	2.1	2.3	2.0	2.1	1.9
Germany	1.5	0.3	1.1	1.7	1.5	1.2	1.2	2.1	1.6
Developing Countries	6.8	9.0	4.6	4.1	2.8	2.9	3.0	3.7	2.9
Asia	2.7	4.4	0.1	1.8	1.1	0.7	2.1	3.3	2.1
Korea	5.0	5.8	1.2	2.6	3.4	3.4	3.5	3.7	3.4
China	0.8	-1.2	-1.0	0.9	-0.1	-0.6	2.6	3.7	1.6
Latin America	15.5	15.4	12.5	8.4	5.3	6.5	4.9	4.4	4.1
Mexico	17.0	17.3	13.4	8.7	5.1	5.3	4.0	3.9	3.8
Brazil	4.6	2.0	8.4	6.4	7.5	10.7	11.5	6.2	5.2

1. Foreign GDP aggregates calculated using shares of U.S. exports.

2. Harmonized data for euro area from Eurostat.

3. Foreign CPI aggregates calculated using shares of U.S. non-oil imports.

4. CPI excluding mortgage interest payments, which is the targeted inflation rate.

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

Measure and country	2003				2004				Projected			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
REAL GDP (1)	----- Quarterly changes at an annual rate -----											
Total foreign	1.0	0.8	4.1	4.8	4.3	4.0	3.7	3.6	3.6	3.5	3.4	3.4
Industrial Countries	2.8	-0.7	1.4	3.3	2.4	4.1	3.7	3.4	3.6	3.6	3.5	3.5
of which:												
Canada	0.2	3.8	2.7	7.3	6.1	3.8	3.0	2.7	2.5	2.3	2.3	2.3
Japan	1.1	2.4	3.4	3.7	2.5	3.1	3.0	3.0	2.8	2.7	2.6	2.6
United Kingdom	-0.0	-0.3	1.7	1.5	2.3	1.6	1.7	1.9	1.8	1.8	1.9	1.9
Euro Area (2)	-1.0	-0.7	0.8	1.1	1.8	0.6	0.9	1.4	1.3	1.4	1.7	1.7
Germany												
Developing Countries	0.2	1.7	7.6	7.0	6.6	5.2	4.7	4.6	4.6	4.5	4.3	4.3
Asia	3.6	-2.8	15.3	8.6	7.9	5.9	5.4	5.2	5.3	5.3	5.1	5.1
Korea	-1.1	-0.2	6.7	11.3	3.2	5.0	5.1	5.1	5.0	5.0	5.0	5.0
China	16.3	-2.9	19.6	7.9	15.9	6.9	6.2	6.2	7.3	7.3	7.3	7.3
Latin America	-3.6	5.8	0.9	6.0	5.6	4.7	4.2	4.1	4.0	3.8	3.8	3.7
Mexico	-1.7	4.6	-0.4	5.6	5.4	5.3	4.6	4.5	4.3	4.1	4.0	3.9
Brazil	-4.6	-3.5	2.1	5.9	6.8	2.5	2.5	2.5	3.0	3.0	3.0	3.0
CONSUMER PRICES (3)	----- Four-quarter changes -----											
Industrial Countries	2.4	1.7	1.4	1.3	0.8	1.5	1.5	1.5	1.5	1.4	1.4	1.5
of which:												
Canada	4.5	2.8	2.1	1.7	0.9	1.9	2.0	1.8	1.7	1.6	1.7	1.7
Japan	-0.3	-0.2	-0.5	-0.4	-0.3	-0.3	0.0	0.1	0.1	0.2	0.3	0.3
United Kingdom (4)	1.5	1.3	1.4	1.3	1.2	1.6	1.5	1.3	1.3	1.4	1.6	1.8
Euro Area (2)	2.3	1.9	2.1	2.0	1.7	2.4	2.2	2.1	2.2	1.8	1.9	1.9
Germany	1.1	0.9	1.0	1.2	1.0	2.2	2.1	2.1	2.2	1.5	1.6	1.6
Developing Countries	3.4	3.0	2.6	3.0	3.0	3.6	4.0	3.7	3.6	3.2	3.1	2.9
Asia	1.2	1.1	1.1	2.1	2.2	3.2	3.7	3.3	3.2	2.6	2.3	2.1
Korea	4.1	3.3	3.2	3.5	3.3	3.4	4.0	3.7	3.8	4.1	3.8	3.4
China	0.4	0.7	0.9	2.6	2.8	4.3	4.6	3.7	3.4	2.2	1.8	1.6
Latin America	7.1	6.4	5.4	4.9	4.7	4.5	4.5	4.4	4.1	4.2	4.3	4.1
Mexico	5.5	4.7	4.1	4.0	4.3	4.3	4.0	3.9	3.7	3.8	4.0	3.8
Brazil	15.7	17.0	15.3	11.5	6.8	5.4	6.1	6.2	5.7	5.5	5.3	5.2

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

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	1997	1998	1999	2000	2001	2002	2003	Projected 2004	Projected 2005
NIPA REAL EXPORTS and IMPORTS									
Percentage point contribution to GDP growth, Q4/Q4									
Net Goods & Services	-0.8	-1.1	-1.0	-0.9	-0.2	-0.9	-0.0	-0.5	-0.4
Exports of G&S	0.9	0.3	0.6	0.7	-1.3	0.3	0.6	0.9	0.8
Imports of G&S	-1.7	-1.4	-1.6	-1.6	1.1	-1.2	-0.6	-1.3	-1.2
Percentage change, Q4/Q4									
Exports of G&S	8.3	2.6	5.6	6.5	-11.5	3.3	6.4	8.8	8.0
Services	0.4	4.4	5.3	1.8	-8.3	9.3	4.8	6.5	5.9
Computers	26.7	7.3	13.4	22.7	-22.8	-0.9	11.3	9.8	19.2
Semiconductors	21.1	9.5	34.6	27.6	-34.9	9.7	38.8	28.3	41.2
Other Goods 1/	9.8	1.2	3.3	5.9	-9.8	0.4	5.0	8.6	6.2
Imports of G&S	14.3	11.0	12.1	11.2	-7.4	9.4	4.5	9.3	8.1
Services	11.9	10.4	6.5	10.7	-4.6	6.7	0.1	6.2	5.0
Oil	4.2	4.2	-3.4	13.3	0.1	3.7	2.2	1.5	1.2
Computers	32.6	26.4	26.0	13.9	-12.9	13.5	17.1	26.1	23.8
Semiconductors	32.5	-7.7	34.2	22.8	-51.3	9.7	0.4	43.5	41.2
Other Goods 2/	13.1	11.2	12.9	10.5	-6.2	10.3	5.1	9.4	7.8
Billions of Chained 2000 Dollars									
Net Goods & Services	-104.6	-203.8	-296.2	-379.5	-398.1	-470.6	-509.1	-547.7	-594.6
Exports of G&S	943.7	966.5	1008.2	1096.3	1039.0	1014.2	1034.7	1138.2	1234.8
Imports of G&S	1048.3	1170.3	1304.5	1475.8	1437.1	1484.7	1543.8	1685.9	1829.4
Billions of dollars									
US CURRENT ACCOUNT BALANCE	-136.0	-209.6	-296.8	-413.5	-385.7	-473.9	-530.7	-606.5	-702.3
Current Acct as Percent of GDP	-1.6	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-5.2	-5.7
Net Goods & Services (BOP)	-108.2	-164.9	-263.3	-378.4	-362.7	-421.7	-496.5	-573.2	-627.0
Investment Income, Net	17.0	8.3	18.4	25.3	28.7	12.6	38.8	52.1	12.2
Direct, Net	72.4	65.5	78.2	94.9	115.9	100.8	118.9	152.2	164.0
Portfolio, Net	-55.4	-57.2	-59.8	-69.7	-87.2	-88.2	-80.1	-100.2	-151.8
Other Income & Transfers, Net	-44.8	-53.0	-52.0	-60.4	-51.7	-64.8	-72.9	-85.4	-87.5

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

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	2000				2001				2002			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA REAL EXPORTS and IMPORTS												
	Percentage point contribution to GDP growth											
Net Goods & Services	-1.5	-1.0	-0.9	-0.1	0.5	-0.2	-0.4	-0.5	-0.7	-1.3	-0.2	-1.5
Exports of G&S	0.7	1.3	1.1	-0.3	-0.5	-1.5	-2.0	-1.0	0.4	0.8	0.4	-0.4
Imports of G&S	-2.2	-2.3	-2.0	0.2	1.0	1.3	1.6	0.5	-1.1	-2.1	-0.6	-1.1
	Percentage change from previous period, s.a.a.r.											
Exports of G&S	6.6	12.3	10.7	-2.7	-4.5	-13.4	-17.7	-9.8	4.4	8.7	4.3	-3.7
Services	1.4	8.4	-6.6	4.5	-2.0	-0.6	-14.7	-15.0	22.9	1.6	4.4	9.4
Computers	32.7	47.0	30.1	-10.7	-7.7	-40.8	-20.1	-18.6	-22.2	3.2	4.6	14.6
Semiconductors	24.2	73.7	35.0	-8.9	-29.5	-54.1	-45.7	2.3	26.6	40.5	11.8	-27.1
Other Goods 1/	5.9	7.5	16.0	-4.5	-2.7	-12.1	-16.6	-7.4	-2.8	10.8	3.7	-9.0
Imports of G&S	16.7	16.5	14.1	-1.6	-6.2	-8.5	-10.8	-3.8	8.4	17.1	4.1	8.2
Services	20.9	10.6	14.3	-1.8	-3.2	12.5	-18.1	-6.9	19.3	-3.7	0.7	12.1
Oil	28.5	40.6	-2.6	-6.4	23.3	7.1	-26.8	3.7	-19.3	35.3	-10.9	18.9
Computers	-2.2	44.9	35.4	-12.3	-25.7	-20.5	-10.9	9.3	38.4	11.5	6.5	0.9
Semiconductors	25.0	45.4	71.1	-26.9	-43.5	-70.4	-55.4	-24.6	44.5	34.6	-6.5	-20.3
Other Goods 2/	16.4	12.2	12.2	1.8	-6.1	-10.0	-4.8	-4.0	5.9	21.4	7.0	-7.5
	Billions of Chained 2000 Dollars, s.a.a.r.											
Net Goods & Services	-350.6	-374.5	-395.6	-397.2	-385.9	-391.7	-401.3	-413.4	-431.2	-467.6	-471.9	-511.5
Exports of G&S	1060.9	1092.0	1120.0	1112.3	1099.6	1060.9	1010.6	984.8	995.4	1016.5	1027.3	1017.5
Imports of G&S	1411.5	1466.5	1515.6	1509.5	1485.5	1452.7	1411.9	1398.2	1426.7	1484.1	1499.2	1529.0
	Billions of dollars, s.a.a.r.											
US CURRENT ACCOUNT BALANCE	-391.5	-394.3	-428.8	-439.2	-426.8	-390.2	-367.6	-358.3	-440.8	-471.6	-476.0	-507.4
Current Account as % of GDP	-4.1	-4.0	-4.3	-4.4	-4.3	-3.9	-3.6	-3.5	-4.3	-4.5	-4.5	-4.8
Net Goods & Services (BOP)	-358.4	-361.8	-387.5	-405.7	-389.3	-356.1	-357.1	-348.3	-375.0	-413.5	-427.7	-470.7
Investment Income, Net	20.1	22.8	17.1	41.1	23.9	29.8	1.5	59.7	9.2	1.8	10.6	28.8
Direct, Net	84.5	88.9	91.9	114.5	106.2	116.1	95.0	146.2	100.6	95.1	94.9	112.8
Portfolio, Net	-64.4	-66.1	-74.8	-73.4	-82.3	-86.3	-93.5	-86.6	-91.4	-93.2	-84.3	-84.0
Other Inc. & Transfers, Net	-53.1	-55.3	-58.4	-74.6	-61.3	-63.9	-12.0	-69.7	-75.0	-59.9	-59.0	-65.4

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

OUTLOOK FOR U.S. INTERNATIONAL TRANSACTIONS

	2003				2004				Projected			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA REAL EXPORTS and IMPORTS												
	Percentage point contribution to GDP growth											
Net Goods & Services	0.8	-1.3	0.8	-0.3	-0.7	7.4	9.7	10.8	-0.6	0.0	-0.4	-0.6
Exports of G&S	-0.2	-0.1	0.9	1.8	0.7	0.7	1.0	1.1	0.7	0.8	0.8	0.9
Imports of G&S	1.0	-1.2	-0.1	-2.1	-1.4	-0.8	-1.4	-1.7	-1.2	-0.8	-1.2	-1.5
	Percentage change from previous period, s.a.a.r.											
Exports of G&S	-2.0	-1.1	9.9	20.5	7.4	7.4	9.7	10.8	6.8	8.3	7.9	9.0
Services	-10.2	0.3	12.7	18.8	3.1	8.4	7.6	7.1	6.5	6.0	5.7	5.5
Computers	-7.4	-11.2	48.7	25.7	-9.6	1.2	26.0	26.1	12.6	21.5	21.5	21.5
Semiconductors	44.1	30.1	35.2	46.4	14.6	6.2	49.3	49.3	33.6	43.9	43.9	43.9
Other Goods 1/	0.1	-3.0	4.8	19.3	10.3	7.4	7.4	9.4	4.8	6.3	5.8	7.7
Imports of G&S	-6.8	9.1	0.8	16.4	10.2	5.6	9.8	11.7	8.2	5.5	8.3	10.3
Services	-7.6	-10.9	13.5	7.5	1.1	9.4	7.4	7.0	5.5	4.9	4.9	4.8
Oil	-12.7	55.8	-3.2	-17.0	41.9	-39.0	1.2	21.2	11.8	-24.3	-0.1	24.1
Computers	-0.4	18.9	15.8	36.8	12.7	30.9	30.9	30.9	17.0	26.1	26.1	26.1
Semiconductors	-0.4	3.1	-1.5	0.5	42.5	33.8	49.3	49.3	33.6	43.9	43.9	43.9
Other Goods 2/	-6.4	9.1	-2.5	22.8	8.1	10.3	9.3	9.6	7.2	7.7	8.0	8.3
	Billions of Chained 2000 Dollars, s.a.a.r.											
Net Goods & Services	-490.0	-526.0	-505.2	-515.2	-534.9	-537.3	-550.3	-568.3	-583.5	-583.6	-596.4	-614.9
Exports of G&S	1012.4	1009.6	1033.7	1083.1	1102.6	1122.6	1148.9	1178.7	1198.2	1222.2	1245.7	1272.9
Imports of G&S	1502.5	1535.7	1538.9	1598.3	1637.5	1659.9	1699.2	1747.0	1781.7	1805.8	1842.1	1887.8
	Billions of dollars, s.a.a.r.											
US CURRENT ACCOUNT BALANCE	-552.8	-535.5	-526.5	-507.8	-579.5	-580.6	-617.3	-648.5	-679.5	-682.3	-706.1	-741.1
Current Account as % of GDP	-5.1	-4.9	-4.7	-4.5	-5.1	-5.0	-5.2	-5.4	-5.6	-5.5	-5.7	-5.9
Net Goods & Services (BOP)	-501.6	-493.5	-489.0	-502.0	-547.7	-558.3	-581.5	-605.3	-618.6	-615.9	-627.7	-645.7
Investment Income, Net	21.5	29.1	34.5	70.1	56.3	61.8	48.6	41.7	33.7	18.3	6.6	-9.9
Direct, Net	101.3	105.4	114.6	154.2	142.0	156.2	152.6	158.1	162.9	162.8	165.9	164.3
Portfolio, Net	-79.8	-76.3	-80.1	-84.1	-85.7	-94.4	-104.0	-116.5	-129.2	-144.5	-159.3	-174.2
Other Inc. & Transfers, Net	-72.8	-71.0	-72.0	-76.0	-88.1	-84.1	-84.4	-84.9	-94.6	-84.7	-85.1	-85.5

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