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UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

U.S. ECONOMIC OUTLOOK

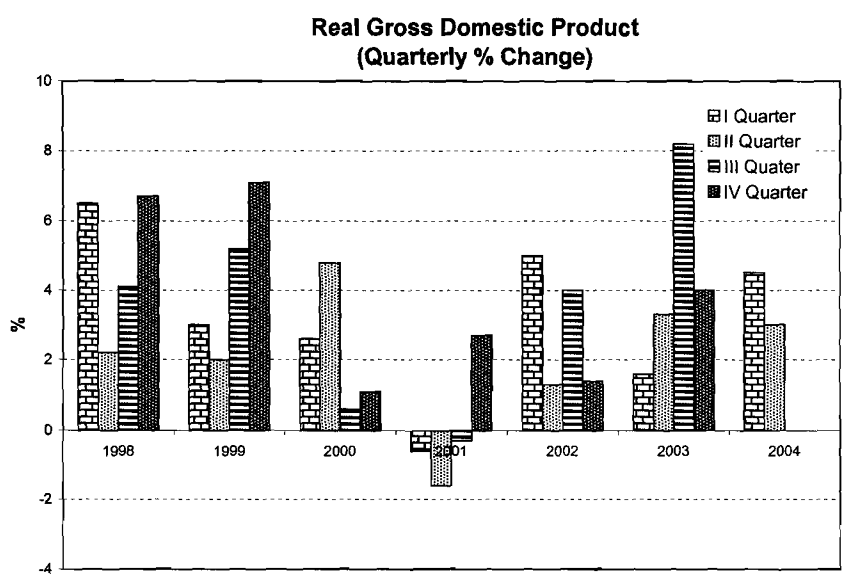
After growing at a rate of 4.5% in the first quarter of 2004, the U.S. economy slowed down to a 3% rate in the second quarter. The slower than expected growth, a weak labor market, and high energy prices have once again cast some doubt about the self-sustainability path to recovery.

In recent months, the pace of improvement in labor market conditions slowed down, with only 32,000 new jobs created in July. Consumer spending has also showed some signs of softness, partly due to higher prices but also because of slower employment gains. Business spending, on the other hand, has been strengthening.

When the Federal Open Market Committee (FOMC) decided to raise the federal funds rate to 1.5% in its last meeting on August 10th, it acknowledged signs of economic slowing but said the softness in output and labor market growth could be attributed in large part to the rise in energy prices and likely to be temporary. The Fed said that the economy appears poised to achieve a stronger pace of expansion going forward. It suggested, as well, that a September hike in the interest rate will remain dependent on data, in particular the non-auto sales figures, consumer spending, factory activity, and the labor market.

I. CURRENT ASSESSMENT

- **GDP growth**



Gross domestic product rose at a moderate 3.0% in the second quarter compared to a solid 4.5% growth rate in the first quarter, due, for the most part, to a remarkable slowdown in consumer spending. Real consumption rose at a 1.0% annualized rate in the second quarter, the weakest showing by consumer spending in three years. Spending on durable goods fell 2.5%, while spending on nondurable also edged down for the quarter. Consumption of services rose 2.3%, but this was the lowest gain in three quarters.

Business investment improved for the quarter. Fixed investment rose a solid 8.8%, more than double the first quarter gain. Business spending on structures rose 5.7%, while investment in equipment and software rose 10.0%. Equipment spending was weaker than expected for the quarter.

Trade activity remained unchanged for the quarter with respect to the previous quarter. Exports did rise at a strong 13.2% rate but imports also posted a large 9.3% gain for the quarter. Given the larger volume of imports in the trade flows, this smaller percentage gain ensured an increase in the trade deficit for the quarter nonetheless.

Government spending posted a moderate 2.3% real gain for the quarter.

- **Sectoral Developments**

Industrial production increased 0.4% in July, which was less than expected. During the second quarter, industrial production grew only at a 4.9% rate, down form 6.6% in the first quarter. Manufacturing production was up 0.6% in July, in response to large increases in both durables and nondurables. Mining production was strong, with increases in coal mining and in oil and gas extraction.

Capacity utilization rates for total industry rose 0.2 percentage points in July, to 77.1%, below what was expected.

Despite the impact of two rises in interest rate, the housing market remains strong, with rises in existing home sales as well as new houses.

Industrial Outlook

2003/2004	Total Industrial Production		Capacity Utilization Rate (%)
	Index 1997=100	Percentage Change From Previous Month	Total Industry
2003 Q1	110.5		75.2
January	110.8	0.8	75.4
February	110.7	-0.1	75.3
March	110.1	-0.5	74.8
2003 Q2	109.4		74.2
April	109.5	-0.5	74.3
May	109.5	0.0	74.3
June	109.3	-0.1	74.1
2003 Q3			
July	110.8	0.8	74.5
August	110.9	0.0	74.5
September	111.5	0.6	74.9
2003 Q4			
October	111.8	0.3	75.0
November	112.9	1.0	75.7
December	113.1	0.2	75.8
2004 Q1			
January	113.8	0.6	76.2
February	114.6	0.7	76.6
March	114.5	-0.1	76.5
2004 Q2			
April	115.3	.5	76.8
May	116.3	.9	77.4
June	115.8	-.5	76.9
2004 Q3			
July	116.2	.4	77.1

- **Labor markets**

Labor markets started to show some strength in the first quarter of 2004. However, after very solid job gains –an average of 300,000 jobs a month, in March, April and May, job growth slowed down significantly in June and July when only 110,000 workers were added to payrolls. The slowdown in July was mainly due to a drop in

Unemployment Rate (%)

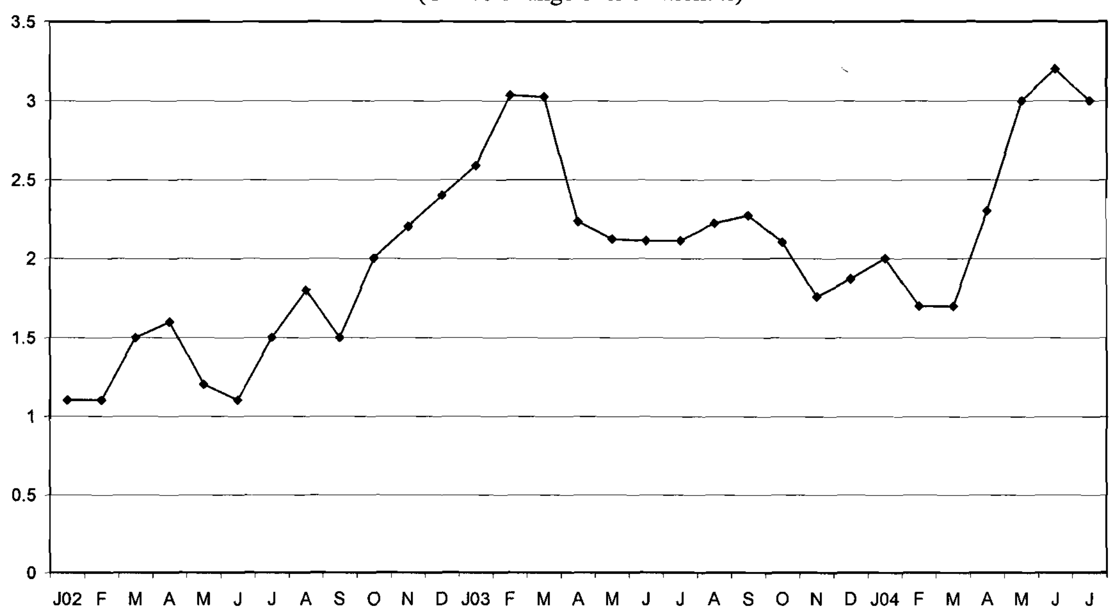
services sector jobs. Among the services industries that shed payroll workers were financial services, retail trade, information, social services, and leisure/hospitality services. Government employment was also down 5,000 in June, the second straight decline. For the year, government employment is down slightly. Construction and retail also showed null to modest gains.

The unemployment rate in July stands at 5.5 percent, down from a 5.6 percent rate unchanged since February.

- **Prices and Monetary Policy**

After holding the overnight federal funds rate at 1% for almost a year, the Federal Reserve raised the interest rate 25 basis points to 1.25% in its June meeting, and again by 25 basis points to 1.5% in its August meeting. The Fed's balanced statement accompanying its decision points to a gradual tightening of the monetary policy.

Evolution of Domestic Prices
(CPI % Change over 12 months)



The Fed has been very explicit about where it stands and what its future moves might be. It perceives the upside and downside risks to the attainment of both sustainable growth and price stability as "roughly equal". Thus, with underlying inflation expected to be relatively low, the Fed believes that policy accommodation "can be removed at a pace that is likely to be measured." The predominant view among FOMC members is that much of the early 2004 inflation is temporary and it will remain contained. However, since there is always some degree of uncertainty, the Fed has given itself plenty of flexibility by signaling to markets that its intention to move gradually is conditional on inflation staying "relatively" low. The gradual path towards a more tightened monetary policy could be threatened if there is an unexpected surge in inflation –i.e. oil prices continues to rise, or, more likely, there is a slowdown in productivity that raises labor costs.

- **Financial Markets**

Despite strong corporate earnings, the stock market was little changed for the quarter. Future developments in the stock market will likely depend on how fast and how far the Fed pushes interest rates. Also, corporate earnings have been very strong so far but due to the uncertainty over the situation in Iraq and over the Presidential election have not showed up in the stock market.

The year 2004 could bring more challenges for the dollar. Rather than focusing on the economy, investors worry about the deficit in the U.S. current account, which has climbed to about 5 percent of GDP, and short-term interest rates that are well below similar rates in Europe and many other parts of the world. Terror threats are also weighting on the dollar.

So far, bond yields in the U.S. haven't reflected the dollar's weakness, in part because U.S inflation remains low and the labor market still has enough slack. Both factors convince many bond investors that the Fed's rate increases will not be too large.

While investors in the U.S. and abroad have shed dollars, foreign central banks and official institutions continue to buy and hold large amounts of dollar-denominated assets, primarily U.S. Treasury securities, helping to keep Treasury yields low.

LOOKING AHEAD

The latest Federal Reserve projections for the U.S. economy are:

- An increase in real GDP of 4.5% to 4.75% over the four quarters of 2004 and 3.5% to 4% in 2005
- The unemployment rate between 5.25% and 5.5% in the fourth quarter of 2004, and between 5% and 5.25% by the fourth quarter of 2005
- The core PCE price index between 1.75% and 2% in 2004 and between 1.5% and 2% in 2005