



Monthly Economic Outlook

January 14, 2005

U.S. Overview

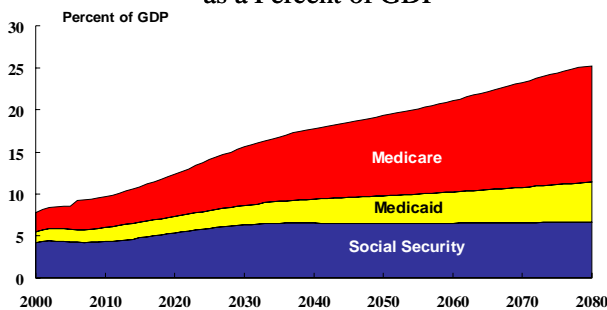
Even With Trend Growth Have We Promised Too Much?

Real growth of 3.2 percent this year may not be enough to reconcile the promises of deficit reduction and entitlement reform (see graph below left). Public policymakers may have promised too much for a trend growth economy to deliver. Growth may not be fast enough to reduce fiscal deficits while providing the revenue to pay for entitlements. This year may be the year to face the economic music and start making real choices.

Economic growth is projected at 3.2 percent in 2005 after a gain of 4.4 percent last year. All three basic elements of final demand (consumption, investment and government spending) are expected to contribute to growth. In typical mid-cycle fashion, however, housing starts are expected to decline while total vehicle sales are flat. The period of rapid growth in consumer durable spending has past.

Inflation, as measured by the core consumer price index, is expected to rise to 2.3 from 1.8 percent last year. This pace of acceleration is not expected to accelerate the measured pace of interest rate increases by the Fed. We still estimate a fourth quarter fed funds rate at 3.75 percent. Our estimate of the benchmark Treasury rate is expected to hit 5.1 percent reflecting our view of the combined impact of rising Fed restraint, economic growth, inflation and dollar weakness.

Social Security, Medicare, and Medicaid Spending as a Percent of GDP



Note: Social Security and Medicare projections based on the intermediate assumptions of the 2004 Trustees' Reports. Medicaid projections based on CBO's January 2004 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

International Overview

On a trade-weighted index of major currencies, the value of the dollar has declined almost 30% relative to its peak in early 2002. However, on a broader trade-weighted measure the dollar is down only 15% over the past three years because most currencies in non-Japan Asia have strengthened much less against the greenback. In addition, Mexico accounts for 11% of total U.S. trade, and the dollar has appreciated 25% versus the Mexican peso since early 2002.

Between 1985 and 1988 the real value of the dollar declined by 30%. (It currently is down only 15% relative to its peak in early 2002.) However, the current account deficit continued to widen until late 1987/early 1988 when it began to stabilize and then subsequently narrow. Slower economic growth in the U.S. in the late 1980's, which helped to rein in import growth, and faster growth abroad, which stimulated U.S. exports, contributed to the adjustment in the U.S. current account deficit in the late 80's.

Although the dollar at present is nearly three years off its peak, the U.S. current account deficit has yet to show any signs of stabilizing. This seemingly paradoxical result, in which the current account deficit continues to deteriorate despite currency depreciation, is normal and is known as the "J curve." However, a significant correction in the current account deficit will require some combination of slower U.S. growth, faster foreign growth, and further dollar depreciation.

U.S. Current Account Deficit

(billions of Dollars, 4-Quarter Moving Average)



— 1985-1989, left hand scale — 2002-Present, right hand scale

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Fundamentals Support Growth--Just at a Slower Pace

Income growth, positive financial support, productivity gains and trend demographics support the case for trend growth this year. These fundamentals are the building blocks of an economic expansion. For this year we expect growth of 3.2 percent with broad-based gains in all three domestic demand sectors of consumer spending, investment and government spending.

Income growth and positive demographics provide the basis for consumer gains. Real disposable income growth of 2.8 percent is expected in 2005 as both compensation and employment improve. We have a modest decline in unemployment in the outlook while the growth of the population continues to support overall economic growth. Consumer spending (graph, lower left) is expected to rise at a three percent annual rate during the first half of 2005 and 2.9 percent for the entire year. Spending will rise roughly in line with after-tax income growth, which is expected to average a 2.9 percent pace over the next two years.

Investment Spending: A Commitment to Competitiveness Through Capex

Yes, investment spending growth is expected to slow in the year ahead and yet the pace of growth is expected to remain in the six to eight percent range as firms remain committed to achieving competitiveness through technology spending. Spending on equipment and software remains the largest component of investment spending.

The expiration of bonus depreciation at the end of last year will mean a moderation of at least some purchases, particularly for computers and telecom equipment. However, by the second quarter, investment outlays should be rising again, and we are looking for a six percent plus gain by midyear.

One wild card in the investment outlook is the new corporate tax law which will allow companies to repatriate profits from overseas at a low tax rate as long as those profits are used to boost new investment and create new jobs. The

qualifications for this tax break are pretty vague, however, and there is no way of knowing just yet if the Internal Revenue Service guidelines will result in a meaningful boost to the type of investment that impacts real GDP growth.

Federal Spending as the Wild Card for the Economy and the Capital Markets

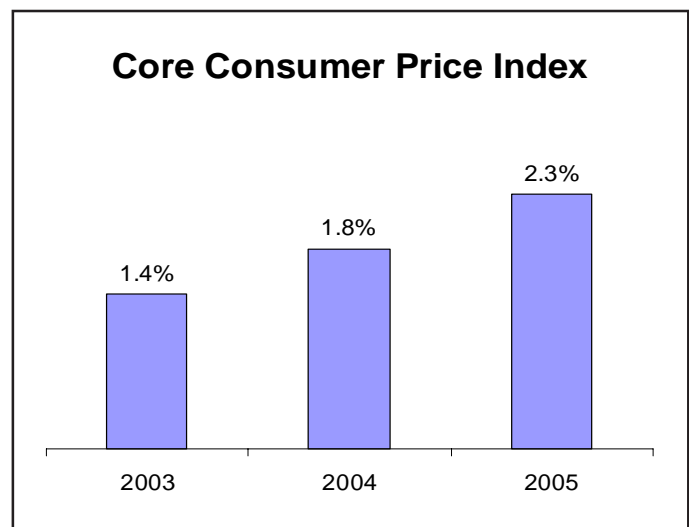
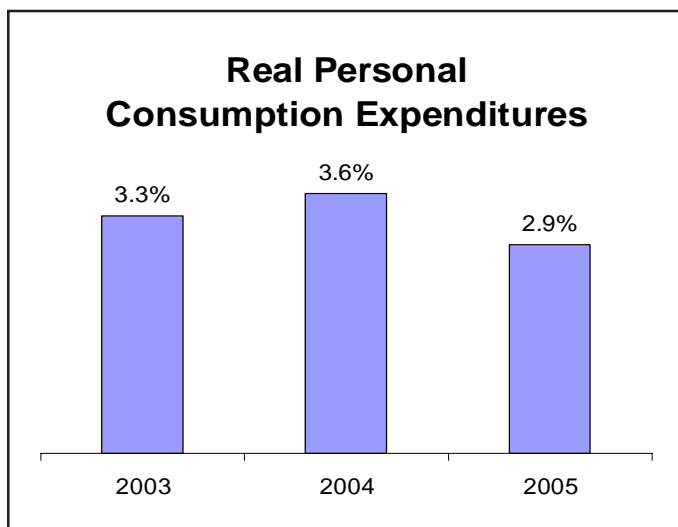
This year is indeed the year of the wild card fiscal policy as the Bush administration attempts to juggle fiscal discipline, social security reform, tax reform and Medicare/entitlement controls. Next month we will receive the latest deficit forecasts from the administration. Will the projected deficits match market expectations for progress in the sense of the reducing structural deficits over the horizon? A disappointing set of deficit estimates will lead to higher estimates of federal spending unfortunately accompanied by rising Treasury rates.

Meanwhile, Social Security reform in the spring will be joined in July by the Presidential Commission report on tax reform. The confluence of all these fiscal policy proposals could lead to confusion with little real progress and a backup in Treasury yields. Federal spending will show its two-edged sword as strong spending boosts final demand and growth while putting upward pressure on bond yields. Markets may discount a lack of fiscal discipline and increasing Treasury supply in a growing economy with rising inflation and thereby price in higher yields.

Inflation and Interest Rates: Rising

At this stage of the economic cycle it is normal for both inflation and interest rates to rise. This pattern is reflected in our outlook. Inflation fundamentals on the upside include the high level of vendor performance, a declining dollar, rising unit labor costs and a relatively low level of unemployment.

Meanwhile, the latest Fed statements reflect the observations by some of the members of the Federal Open Market Committee that inflation risks are on the upside. Over the rest of this year we expect the Fed to raise the Fed funds rate 150bp while long rates rise 90 basis points, thereby leading to a flatter yield curve.



(Percentage Changes)

QUARTER:	Actual	Forecast				2005				2006						
	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	2003	2004	2005	2006
REAL GROSS DOMESTIC PRODUCT(e)	3.8	3.6	2.6	2.9	3.2	3.2	3.1	3.1	3.2	3.2	3.1	3.3	3.0	4.4	3.2	3.2
PERSONAL CONSUMPTION	4.6	2.0	3.4	2.7	2.8	2.8	2.7	2.7	2.8	2.8	2.7	2.6	3.3	3.6	2.9	2.7
BUSINESS INVESTMENT	11.7	12.7	-0.6	4.9	6.0	6.9	7.8	8.3	6.0	6.9	7.8	8.3	3.3	10.3	6.4	7.4
EQUIPMENT & SOFTWARE	14.9	15.3	-3.4	5.1	6.3	7.1	8.1	8.6	6.3	7.1	8.1	8.6	6.4	13.1	6.6	7.7
STRUCTURES	8.0	5.5	3.0	4.0	5.0	6.0	6.5	7.0	5.0	6.0	6.5	7.0	-5.6	1.9	4.1	6.4
RESIDENTIAL CONSTRUCTION	5.5	1.0	-2.0	-1.0	-0.5	-1.0	-0.5	0.5	-0.5	-1.0	-0.5	0.5	8.8	9.7	0.7	-0.2
GOVERNMENT PURCHASES	1.4	2.0	2.4	2.4	2.4	2.4	2.4	2.3	2.4	2.4	2.4	2.3	2.8	2.1	2.2	2.4
NET EXPORTS (\$ BILLIONS)	-598	-598	-589	-585	-582	-579	-576	-574	-582	-579	-576	-574	-518	-582	-584	-573
% Pt. Contribution to GDP	-0.7	0.0	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	-0.5	-0.6	-0.5	0.0
INVENTORY CHANGE (\$ BILLIONS)	48	58	51	48	47	45	41	39	47	45	41	39	-1	52	48	40
% Pt. Contribution to GDP	-0.5	0.4	-0.3	-0.1	0.0	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	0.5	0.4	0.0
NOMINAL GDP	5.1	6.7	5.3	5.4	5.8	5.8	5.8	6.1	5.8	5.8	5.8	6.1	4.9	6.6	5.7	5.9
REAL FINAL SALES	4.2	3.4	2.7	2.7	2.7	2.6	2.6	2.6	2.7	2.6	2.6	2.6	3.1	3.9	3.2	3.3
"CORE" GDP (a)	5.4	3.3	2.5	2.8	3.1	3.1	3.2	3.3	3.1	3.1	3.2	3.3	3.6	4.7	3.2	3.2
CONSUMER PRICE INDEX (b)	2.7	3.4	3.2	2.7	2.6	2.6	2.7	2.8	2.6	2.6	2.7	2.8	2.3	2.7	2.8	2.8
"CORE" CONSUMER PRICE INDEX (b)	1.8	2.2	2.1	2.2	2.3	2.4	2.4	2.5	2.3	2.4	2.4	2.5	1.4	1.8	2.3	2.5
EMPLOYMENT COST INDEX (b)	3.8	3.7	3.8	3.7	3.6	3.7	3.7	3.8	3.6	3.7	3.7	3.8	3.9	3.8	3.7	3.8
REAL DISPOSABLE INCOME	3.5	2.5	3.0	3.4	3.2	3.0	3.0	2.9	3.2	3.0	3.0	2.9	2.3	2.9	2.8	3.0
UNEMPLOYMENT RATE (%)	5.5	5.4	5.4	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	6.0	5.5	5.3	5.1
HOUSING STARTS (MILLIONS)	1.96	1.90	1.87	1.84	1.81	1.78	1.78	1.77	1.81	1.78	1.78	1.77	1.85	1.93	1.83	1.77
TOTAL VEHICLE SALES (MILLIONS)	17.1	17.3	16.9	16.8	16.8	16.9	17.0	17.1	16.8	16.9	17.0	17.1	16.9	16.8	16.9	17.1
INDUSTRIAL PRODUCTION (b)	5.0	4.8	4.6	4.6	4.5	4.4	4.2	4.0	4.5	4.4	4.2	4.0	0.3	4.5	4.5	4.9
CORPORATE PROFITS NIPA B/T (b)	13.9	12.0	11.0	10.0	9.5	9.0	8.8	8.6	10.0	9.5	9.0	8.8	16.8	17.3	10.2	17.1
Quarter End - INTEREST RATES (%) (c)																
FEDERAL FUNDS (Target)	1.75	2.25	2.75	3.00	3.50	3.75	4.00	4.50	3.00	3.50	3.75	4.00	1.06	1.56	3.25	4.50
3 MONTH LIBOR	1.95	2.49	2.85	3.15	3.65	3.85	4.15	4.60	3.15	3.65	3.85	4.15	1.12	1.71	3.38	4.61
PRIME RATE	4.75	5.25	5.75	6.00	6.50	6.75	7.00	7.50	6.00	6.50	6.75	7.00	4.06	4.50	6.25	7.50
3 MONTH T-BILL (BEY)	1.68	2.18	2.80	3.10	3.60	3.85	4.10	4.60	3.10	3.60	3.85	4.10	0.98	1.56	3.34	4.58
2 YEAR T-NOTE	2.63	3.08	3.30	3.60	3.85	4.30	4.50	4.75	3.60	3.85	4.30	4.50	1.54	2.48	3.76	4.81
5 YEAR T-NOTE	3.38	3.63	4.00	4.30	4.60	4.80	4.90	5.30	4.30	4.60	4.80	4.90	2.82	3.40	4.43	5.30
10 YEAR T-NOTE	4.14	4.24	4.40	4.60	4.85	5.10	5.25	5.50	4.60	4.85	5.10	5.25	3.89	4.20	4.74	5.54
30 YEAR T-BOND	4.92	4.85	5.00	5.20	5.40	5.70	5.80	5.90	5.20	5.40	5.70	5.80	5.02	4.95	5.33	5.93

(a) Core GDP equals consumption, business fixed investment and residential investment.

(b) Percent changes from same quarter year ago.

(c) End Of Quarter Estimate

(d) 4-Qtr Moving Average, Percent Change

(e) Qtr/Qtr Percent Change, Annual Rate

1/14/2005

Much has been written about the dollar's depreciation over the past three years. Since February 2002, the dollar has declined about 35% against the euro and roughly 25% versus the British pound, the Canadian dollar, and the Japanese yen. As shown on the front page, the Federal Reserve's "Major Currency" index, which measures the trade-weighted value of the dollar against other major currencies (e.g., the euro, yen, British pound, Canadian dollar, etc.), recently fell to the all-time low that was set in April 1995.

However, it is also clear from the graph on the front page that a broader measure of the dollar's value has not declined as much as it has against the other major currencies. (The currencies contained in the Fed's "Major Currency" index comprise about 55% of U.S. trade in non-oil imports and non-agricultural exports. The "Broad" index accounts for nearly 95% of U.S. trade.) Most non-Japan Asian currencies, which are included in the "Broad" index but not in the "Major Currency" index, have appreciated only modestly against the greenback. Indeed, the Chinese renminbi, which has a 9.8% weight in the "Broad" index, has remained fixed versus the dollar over the past three years. In addition, the greenback has strengthened about 25% versus the Mexican peso, which carries a 11.0% weight in "Broad" index.

Seen in this context, it is not hard to understand why the current account deficit has continued to widen despite the dollar's marked depreciation against the world's other "major" currencies over the past three years. Moreover, it is the real (i.e., price adjusted) value of the dollar that matters for the price competitiveness of U.S. goods versus foreign goods rather than the dollar's nominal value, which is depicted in the graph on the front page. That is, the price competitiveness of U.S. goods could deteriorate despite dollar depreciation if inflation in the U.S. is higher than in the country's major trading partners.

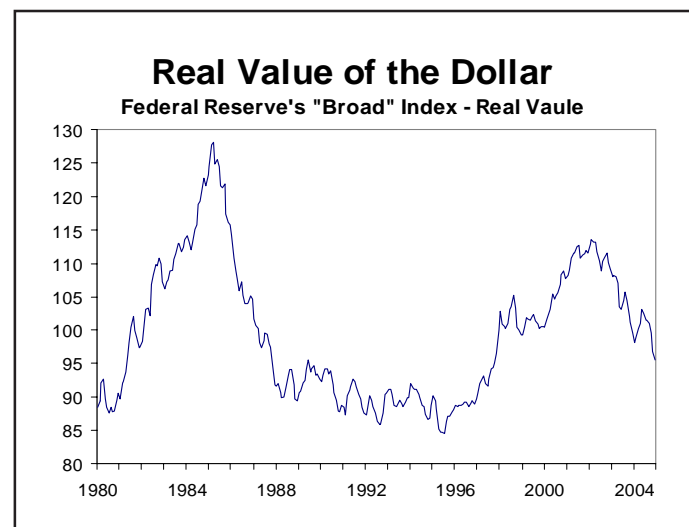
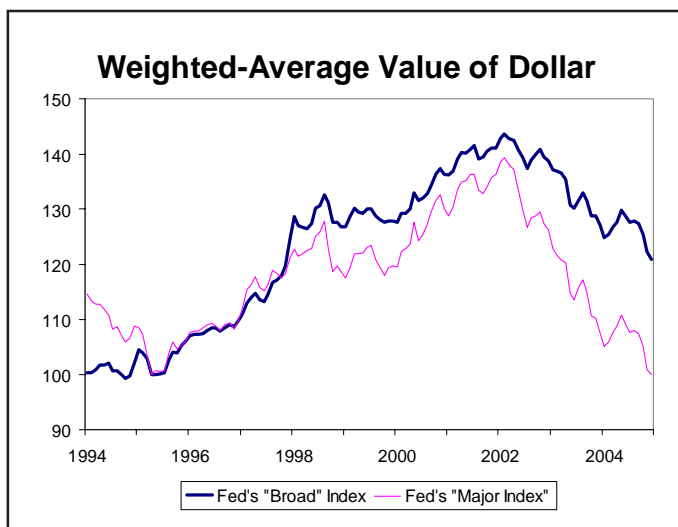
The chart below shows that on a broad trade-weighted basis the real value of the dollar has declined about 15%

over the past three years. Thus, the price competitiveness of U.S. goods *vis-à-vis* foreign goods has improved by about 15% over that period. However, when compared to 1985-1988, the last period of rapid dollar depreciation, the greenback's recent slide does not look so impressive. Between March 1985 and April 1988, the real value of the dollar fell 30%. Moreover, this index remains 13% above the low that was set in the spring of 1995.

The depreciation of the dollar between 1985 and 1988 helped to correct the significant current account deficit that opened up in the 1980's. However, as shown below, the adjustment was not instantaneous. Indeed, the current account deficit continued to widen for about 3 years following the dollar's peak in early 1985. This seemingly paradoxical result, in which the current account deficit continues to widen despite currency depreciation is known as the "J curve." Because trade volumes change slowly, dollar depreciation leads to an initial widening of the current account deficit because it requires more dollars to import an unchanged quantity of imports.

True to the earlier experience, the current account deficit continues to widen now. However, whereas the deficit began to stabilize about 3 years following the onset of dollar depreciation in the 1980's, the deficit is showing little signs of stabilizing yet. The adjustment in the current account deficit in the 80's was helped by slower U.S. growth and faster foreign growth. U.S. growth averaged 5.3% per annum between 1983 and 1985, but it slowed to 3.5% in 1986-89. On the other hand, growth in the rest of the world picked up from 3.5% per annum in 1983-85 to 4.2% in 1986-89. Slower growth in the U.S. helped to rein in growth in imports while faster foreign growth helped to stimulate demand for U.S. exports.

The bottom line is that the U.S current account deficit will remain very large for the foreseeable future. It will require some combination of slower U.S. growth, faster foreign growth, and further dollar depreciation to bring about a significant improvement in the current account deficit.



January 14, 2004

Country	GDP		CPI		3-Month LIBOR								10-Year Bond							
	Growth		Inflation		(end of quarter)								(end of quarter)							
	2004	2005	2006	2004	2005	2006	05-Q1	05-Q2	05-Q3	05-Q4	06-Q1	06-Q2	06-Q3	05-Q1	05-Q2	05-Q3	05-Q4	06-Q1	06-Q2	06-Q3
U.S.	4.4	3.2	3.2	2.7	2.8	2.8	2.85	3.15	3.65	3.85	4.15	4.60	4.85	4.40	4.60	4.85	5.10	5.25	5.50	5.70
Japan	2.9	1.6	2.6	0.0	0.3	0.4	0.05	0.05	0.05	0.05	0.05	0.20	0.40	1.50	1.60	1.70	1.80	2.00	2.20	2.40
Euroland	1.7	1.8	2.5	2.1	2.0	1.9	2.15	2.20	2.40	2.70	2.90	3.20	3.40	3.80*	4.00*	4.15*	4.30*	4.40*	4.45*	4.50*
U.K.	3.1	2.7	2.4	1.3	1.6	1.4	5.00	5.10	5.00	4.70	4.40	4.40	4.40	4.80	4.80	4.70	4.60	4.55	4.60	4.70
Canada	2.7	2.9	2.9	1.8	2.4	2.2	2.90	3.10	3.40	3.70	3.90	4.20	4.20	4.50	4.70	4.90	5.00	5.10	5.20	5.10

Currency	2005-Q1	2005-Q2	2005-Q3	2005-Q4	2006-Q1	2006-Q2	2006-Q3	2006-Q4
Euro (\$/€)	1.30	1.34	1.36	1.38	1.40	1.42	1.44	1.45
U.K. (£/€)	1.86	1.90	1.92	1.93	1.94	1.95	1.96	1.97
U.K. (£/€)	0.70	0.71	0.71	0.72	0.72	0.73	0.73	0.74
Switzerland (CHF/\$)	1.19	1.16	1.15	1.14	1.13	1.12	1.11	1.10
Sweden (SEK/\$)	7.00	6.70	6.55	6.40	6.30	6.15	6.05	6.00
Norway (NOK/\$)	6.40	6.10	6.00	5.85	5.75	5.65	5.50	5.45
Poland (PLN/\$)	3.25	3.10	3.00	2.95	2.85	2.80	2.70	2.65
Japan (¥/\$)	105	102	100	98	96	94	92	90
Australia (US\$/A\$)	0.75	0.74	0.73	0.72	0.71	0.70	0.69	0.68
Singapore (S\$/US\$)	1.66	1.64	1.62	1.60	1.58	1.57	1.56	1.55
Korea (KRW/\$)	1080	1060	1050	1040	1030	1020	1010	1000
Canada (C\$/US\$)	1.26	1.22	1.20	1.18	1.16	1.14	1.13	1.12
Mexico (MXN/\$)	11.40	11.20	11.00	10.90	10.80	10.75	10.70	10.65
Brazil (BRL/\$)	2.80	2.70	2.60	2.50	2.40	2.35	2.30	2.25

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