



The Economic Forecast

Review of fiscal year 2004

The national economic performance was slightly better than anticipated in fiscal year 2004. Strong consumer spending, driven by low interest rates and tax cuts, encouraged businesses to increase capital investment. The labor market showed a marked improvement by Spring 2004. Despite these positives, global uncertainty, including ongoing military operations in Afghanistan and Iraq, continued to be a drag on consumer confidence.

The Virginia economy outperformed the nation's in fiscal year 2004. Like the nation, the Commonwealth's labor market hit an expansionary trend by the spring. Fueled by increases in federal government spending on homeland security and defense, employment growth, particularly in the Northern Virginia region, showed healthy growth in the last quarter of the fiscal year.

The national economy picked up momentum in fiscal year 2004

The U.S. economic expansion gained strength in fiscal year 2004, although the labor market continued to lag throughout much of the year.

Growth in U.S. Gross Domestic Product was close to double the rate of fiscal year 2003. The value of all goods and services produced within the U.S., adjusted for inflation, grew at 4.4 percent in fiscal year 2004. Growth in total personal income was 4.6 percent, while wages and salaries increased by 4.0 percent.

Low interest rates and tax cuts drove consumer spending. Consumer spending grew by 3.8 percent in fiscal year 2004. Stronger wage growth, combined with cash-out refinancing and the tax cuts put more cash in the pockets of consumers, who spent much of the additional disposable income.

The labor market showed signs of improvement, particularly over the final few months of the fiscal year. Total nonagricultural employment in the U.S.

increased by a weak 0.2 percent during fiscal year 2004. The service sectors contributed heavily to the improvement in the labor market. The manufacturing and information sectors continued to shed jobs in fiscal year 2004.

The federal funds rate remained at generational lows throughout fiscal year 2004. The Federal Reserve maintained an accommodative monetary policy with the funds rate at an effective real rate below zero. However, as the labor market began to improve, the Federal Reserve moved to a more neutral policy. The federal funds rate was increased by 25 basis points in June.

Virginia's economy surged over the final quarter of fiscal year 2004

The Commonwealth's labor market could best be described as stagnant through the first half of fiscal year 2004. In December, statewide employment stood at 0.5 percent. However, by April, job growth reached 2.6 percent, a rate more consistent with an expanding economy.

Total nonagricultural employment increased by 66,200 jobs in fiscal year 2004 after falling by 6,400 jobs in fiscal year 2003. Nonagricultural employment grew by 1.9 percent, outpacing the official forecast of a 1.2 percent increase. The service sector was the major driver of growth, along with trade, transportation, and utilities and construction. The manufacturing and information sectors continued to lose jobs, although the pace of

U.S. economy gains strength

	Actual		Forecast	
	2003	2004	2005	2006
Real GDP	2.3%	4.4%	3.8%	3.1%
Total Employment*	(0.6)%	0.2%	1.6%	1.5%
Unemployment	5.9%	5.8 %	5.4%	5.4%
CPI	2.2%	2.2%	2.5%	1.4%

*Total nonagricultural employment. Figures represent percent change over previous year, except unemployment rate, which is a percentage. Data based on the October 2004, Global Insight standard forecast. Source: Department of Taxation

decline did slow.

Here is a look at regional employment in Virginia during fiscal year 2004:

Northern Virginia

In Northern Virginia, which represents about a third of all jobs in the state, employment grew 3.0 percent during fiscal year 2004. The region benefited from its proximity to Washington, D.C., with a significant portion of increased government spending on homeland security flowing to area companies. The professional and business services sub sector, mostly defense-related jobs, added 13,800 new jobs.

Richmond/Petersburg

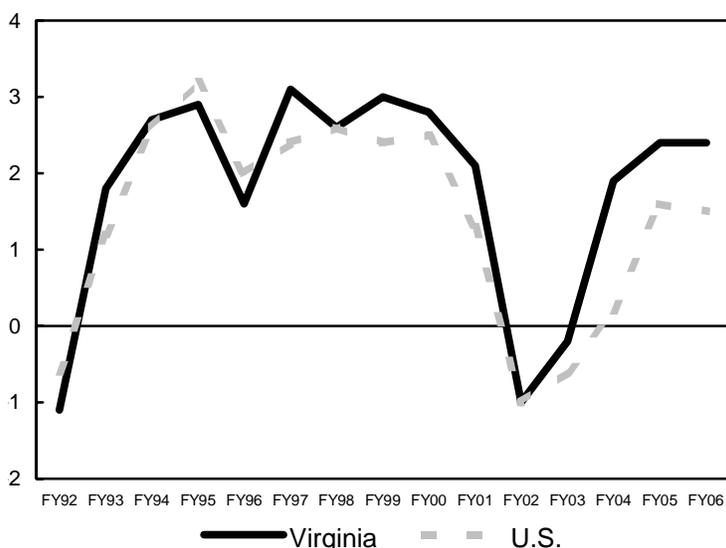
Jobs in the Richmond-Petersburg metropolitan statistical area (MSA) increased by 0.7 percent in fiscal year 2004, an increase of 4,200 jobs. The major drivers of growth were education and health services and financial activities.

Norfolk/Newport News/Virginia Beach

The Norfolk-Newport News-Virginia Beach MSA grew by 1.8 percent, or 13,100 new jobs in fiscal year 2004. The deployment of many of the military personnel due to the Iraq war has remained a drag on growth. The

Virginia employment growth gradually improves over forecast horizon

Percentage growth in nonagricultural employment



manufacturing sector was unchanged from fiscal year 2003 levels, supported by gains in ship and boat building. The tourism industry added 1,300 jobs.

Balance of the state

Employment in the balance of the state increased by 1.3 percent, an additional 13,200 jobs. Gains in professional and business services and education and health services offset losses in the manufacturing sector.

U.S. economic outlook expects continuing expansion

The economic expansion is expected to continue over the forecast horizon. Nationally, employers are finally starting to add jobs at levels associated with a sustained labor market expansion. At the November meeting of the Governor's Advisory Council on Revenue Estimates, the consensus economic forecast was for a steady expansion. Highlights of the economic outlook for the next two years include:

- ▶ Real Gross Domestic Product (GDP) is expected to increase by 3.8 percent in fiscal year 2005 and 3.1 percent in fiscal year 2006.
- ▶ Labor market conditions continue to improve, and job growth is expected to be 1.6 percent and 1.5 percent in fiscal years 2005 and 2006, respectively.
- ▶ Real consumer spending will slow slightly from fiscal year 2004, increasing by 3.2 percent in fiscal year 2005 and 2.9 percent in fiscal year 2006.
- ▶ Business investment is moving from recovery to expansion. Healthy profits and a low user cost to capital have encouraged companies to replace dated information technology equipment with newer technologies.
- ▶ In fiscal year 2005, inflation is expected to experience a slight increase due to higher energy costs, before falling to 1.4 percent in fiscal year 2006.
- ▶ The Federal Reserve Bank is expected to raise the federal fund rate in a measured fashion, increasing to 2.0 percent by the spring of 2005 and 3.0 percent by the end of 2006.

Fiscal year 2005 expected to be a year of solid growth

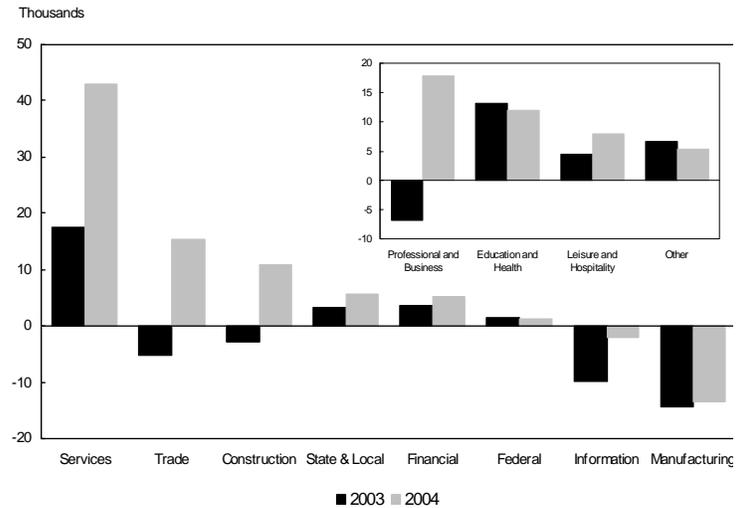
The Virginia economy is well-situated for a period of healthy economic growth. The service sector will continue to drive growth, while the high-tech industry should pull out of its three-year malaise. Continued defense-related spending, as well as low

business costs and strong population growth, are expected to drive Virginia's economic performance over the forecast horizon.

Here is a look at what economists are predicting for Virginia:

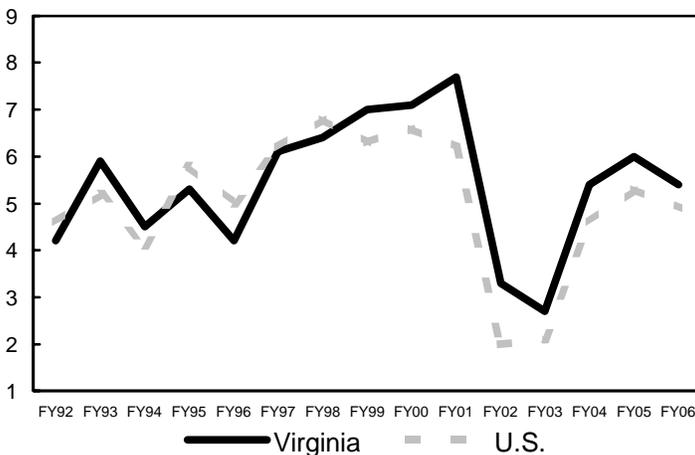
- ▶ Personal income is expected to grow 6.0 percent in fiscal year 2005 and 5.4 percent in fiscal year 2006. Wages and salaries are expected to grow at 5.9 percent in fiscal year 2005 and 5.7 percent in fiscal year 2006.
- ▶ Employment growth of 2.4 percent is expected in both fiscal years 2005 and 2006.
- ▶ Employment in the business and professional services sector is forecast to grow at 5.5 percent in fiscal year 2005 and 3.5 percent in fiscal year 2006.
- ▶ Construction employment is expected to slow slightly in fiscal year 2005, growing at 3.8 percent with further slowing to 1.8 percent in fiscal year 2006.
- ▶ Employment in trade, transportation, and utilities is expected to grow 3.3 percent and 3.7 percent in fiscal years 2005 and 2006, respectively.
- ▶ The forecast expects Virginia's manufacturing sector to begin its recovery by fiscal year 2006. Employment is expected to remain flat in fiscal year 2005 then increase marginally in fiscal year 2006.

VIRGINIA JOB GAINS/LOSSES BY SECTOR
FISCAL YEARS 2003 AND 2004



Personal income growth to exceed the nation's over the forecast horizon

Percentage growth in personal income



Data for 2005 and 2006 are forecasts. Source: Department of Taxation