

CHAPTER II

ECONOMIC ENVIRONMENT

This chapter discusses the economic background and data used to forecast aviation demand. The data used in the FAA forecast come from several sources. U.S. economic data, derived from annual and quarterly statistics, come from the Office of Management and Budget (OMB), Congressional Budget Office (CBO), and a private forecasting service—Global Insight, Inc. (GII). Quarterly data for the three data series used to develop the aviation demand forecasts—Gross Domestic Product (GDP), the Consumer Price Index (CPI), and the Oil and Gas Price Index—are presented as seasonally adjusted, annualized rates.

Federal fiscal year (FY) estimates are calculated by averaging the 4 quarters for the period October through September. GII international economic forecasts provide a basis for the international aviation forecasts. The U.S. economic data are presented on a fiscal year basis, while international economic data are specified on a calendar year (CY) basis, unless otherwise indicated.

REVIEW OF 2004

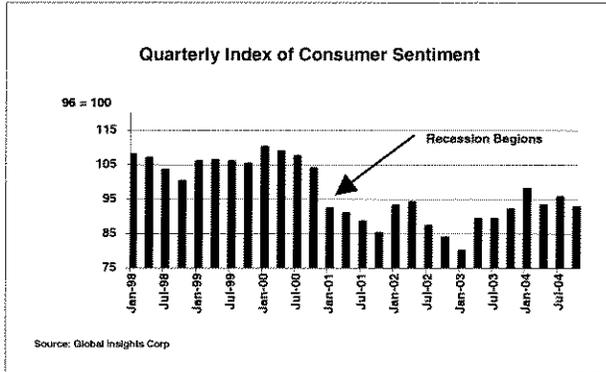
The U.S. economy experienced its 12th consecutive quarter of growth in fourth quarter 2004, an expansion marked by the tensions of the Iraq war and the pervasive threat of terrorism. Although the recovery appears well in progress, the sluggish performance in the labor markets has raised concerns related to the strength of this expansion. The world economic recovery has continued with an expansion particularly brisk in Asia, but somewhat slower in most other regions. However, all major regions of the world showed signs of improving economic conditions.

UNITED STATES

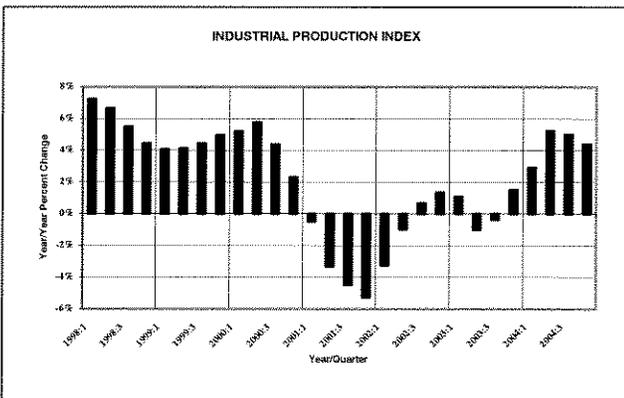
U.S. GDP continued to expand throughout 2004. The economy grew at 4.2 and 4.5 percent in the first 2 quarters; the tempo slowed to 3.3 percent in the third quarter and climbed again to 4.0 percent to end the year.

Consumer confidence, as measured by the University of Michigan's Index of Consumer Sentiment provides a means to view the buying psychology of American consumers who

currently account for about two thirds of the U.S. GDP. The index rose steadily from its recent low point in the second quarter 2003 through the second quarter 2004. However, this leading indicator has remained sluggish through 2004, reaching 95.7 in summer 2004.

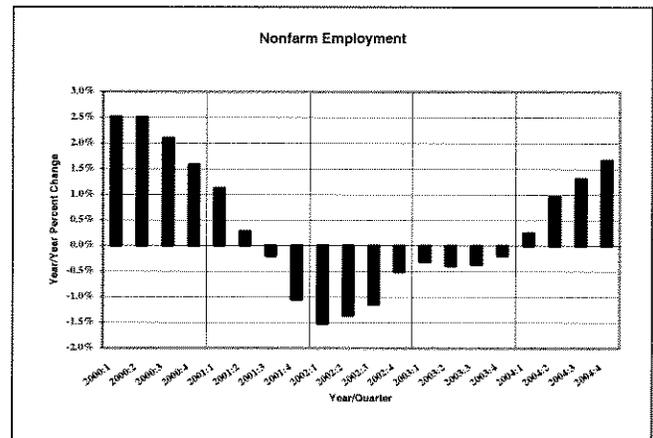


The Industrial Production Index measuring industrial output further illustrates the pattern of recovery in 2004. The chart below shows strength in industrial production in 2004 reversing the recent downward trend since mid-2002. After an up-and-down style recovery since mid-2001, the index has risen for the past 5 quarters. Although the gains are not as high as the late 1990's, industrial production appears growing and stable.



The consumer price index (CPI), a measure of overall price inflation, increased modestly in 2004 with prices rising 2.3 percent, a slightly smaller increase than a year earlier. Highly volatile energy prices rose 13.0 percent following an even larger rise, 18.5 percent, a year earlier.

The chart below shows that nonfarm employment has begun to make gains after 10 consecutive quarters of decline following the recession and terrorist attacks of 2001. Employment rose for every quarter of 2004 with each quarter adding more jobs than the previous. The rise in employment is reflected in the drop in the unemployment rate. The unemployment rate dropped throughout 2004 from 6.0 percent in October 2003 to 5.4 percent in September 2004.



After bringing the Federal Funds rate—the rate on overnight loans between banks—down to its lowest level in two generations, the Federal Reserve Board (FED) began raising interest rates this year. The FED's Federal Open Market Committee raised the federal funds rate to 2.00 percent from 1.75 percent on November 10, 2004; and once more to 2.25 percent on December 14. These were the fourth and fifth consecutive quarter-point increases since July. These increases in the Federal Funds rate caused a rise in the prime rate that banks charge their best customers from 4.75 to 5.25 percent. Prior to the raising of rates this past summer, the FED had lowered interest rates 13 times since the beginning of 2001 as the economy struggled its way out of the recession. The last rate cut was on June 25, 2003 when the Federal Funds rate was lowered to 1.00 percent--a 45-year low.

WORLD

World economic growth grew by 4.2 percent in 2004 up from the much slower 2.8 percent growth in 2003 and an even slower 1.7 percent gain in 2002. Worldwide, in major regions, growth ranged from 5.2 percent in Asia (including Japan) to 2.4 percent in Western Europe.

Although stopping its slide in GDP growth, Western Europe's economic growth continues to lag the rest of the world even with the rise in GDP from 1.0 (2003) to 2.4 percent (2004). Germany and Italy, making up a third of the Western European economy, grew at 1.4 and 1.1 percent, respectively. The German recovery from a recession in 2003 remains weak with domestic demand remaining sluggish and consumer confidence low. Italy likewise, suffers from relatively low consumer confidence.

Eastern Europe grew at a rapid 7.1 percent in 2004, up slightly from last year's 5.8 percent. Several factors are spurring growth, including expanding exports, increased direct foreign investment, and relatively low labor costs. Additionally, rising household incomes and accommodating fiscal and monetary policies have helped to fuel strong growth in public and private demand.

The commodity rich region of the Middle East and North Africa grew by 5.8 percent in 2004, a substantial rise from 3.9 percent a year earlier. Although the Iraqi war and the Israeli-Palestinian conflict continue to enflame discord throughout the region, the rise in oil prices has provided a windfall for this oil rich region.

Asia led the world's major regions in economic growth with a healthy 5.2 percent expansion in 2004, up from 4.0 percent a year earlier. Even Japan, Asia's largest and slowest growing economy over the past decade, grew by

4.1 percent in 2004, up from 2.5 percent last year. China remains the driver among the economies of the orient. Growth in this dynamic region reached 9.1 percent for the second year in a row in 2004.

Latin America economies recovered from their prolonged slump in 2004. The combined economies of South America grew by 5.9 percent in 2004, up from a decline of 2.0 percent in 2002 and growth of only 1.5 percent in 2003. Several factors have worked in favor of the Latin economies, including strong commodity prices, especially in oil, soybeans, and copper; and a depreciation of currencies, particularly in Brazil and Argentina.

G-7 countries¹ make up two-thirds of the world's GDP. GDP growth among these countries ranged from a low of 1.1 percent in Italy to a high of 4.4 percent in the U.S. Japan broke out of its slump by expanding 4.1 percent in 2004. Canada grew by 3.0 percent while the U.K., France, and Germany expanded by 3.2, 2.5, and 1.4 percent, respectively.

Price inflation has remained modest in all the G-7 countries. In 2004, inflation measured by a consumer price index, showed the U.S. having the highest inflation rate among the G-7 with a 2.6 percent rise in prices; Japan experienced a relatively mild deflation of prices, declining by 0.2 percent. Price changes in the other G-7 nations ranged from 1.7 percent in Germany to 2.3 percent in Italy.

Among G-7 nations, short-term interest rates ran from a high of 4.6 percent in the United Kingdom (UK) to a low of zero in Japan. Germany, France and Italy had a 2.1 percent rate in line with European Union (EU) policy. The U.S and U.K. raised their short-term rates by 30 and 40 basis points, respectively. EU nations lowered their rates by 20 basis points, while the Japanese rate remained unchanged at zero.

¹ United States, Canada, the United Kingdom, Germany, Italy, France, and Japan.

Once again all six of the G-7 nations appreciated their currencies against the dollar in 2004. The UK appreciated its currency most with the Pound increasing its value 11.1 percent relative to the dollar. The Euro, Japanese yen, and the Canadian dollar appreciated by 8.9, 6.8, and 7.5 percent, respectively. Hence, U.S. purchases of goods and services from other G-7 countries have become more costly, while visits to the U.S. from abroad have become less expensive.

U.S. ECONOMIC OUTLOOK

The economic assumptions used to develop FAA's baseline aviation forecasts are derived from estimates provided by the Office of Management and Budget (OMB). GDP is measured using Bureau of Economic Analysis (BEA) 2000 chain-weighted estimates.² Forecasts for the Congressional Budget Office (CBO) and Global Insight Inc. (GII) are also shown.

SHORT-TERM ECONOMIC OUTLOOK

Graphics on the following page show a favorable forecast for economic growth during the next 2 years. Although not as robust as the 4.6 percent growth in 2004, OMB projects GDP to grow at 4.0 percent for the first half of the 2005, falling to 3.3 and 3.5 percent for the last two quarters. For 2005 growth is pegged at 3.6 percent for the first quarter and then leveling

off to 3.5 percent. GII views 2005 somewhat less confidently with growth at about 3.6 percent in the first quarter of 2004, but dropping rapidly to 2.9 in the second quarter and fluctuating between 3.3 and 2.8 percent to the end of 2006. CBO predicts somewhat more rapid growth over the next 2 years with growth rates between 3.6 and 3.8 for 2005 and between 3.7 and 3.9 during 2006.

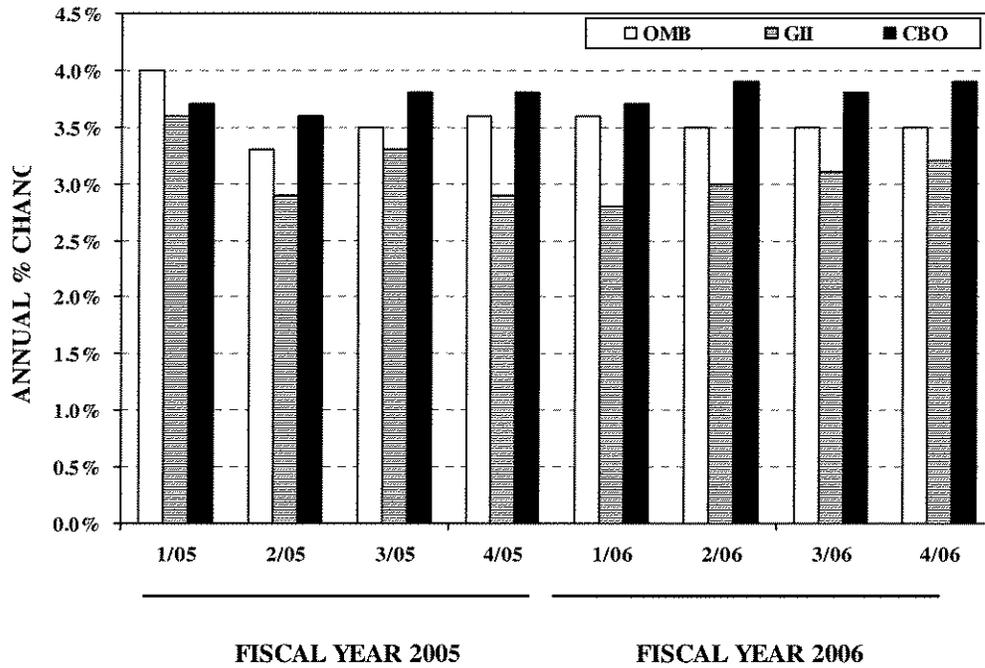
Moderate price inflation is expected to continue to complement the continued economic growth in 2005 and 2006. OMB projects price inflation, as measured by the CPI, to rise from 1.9 percent in the first quarter to 3.6 percent, fall to 1.7 percent in the third quarter, and then rise to 2.3 percent over the next 6 quarters. GII and CBO each project price increases at more moderate levels than OMB over the next 2 years.

Fuel prices, as measured by the oil and gas price index, were up 13.9 percent in 2004 and are expected to rise sharply (21.3 percent) in 2005 based on the OMB forecast. Fuel prices are expected to spike sharply in the first-quarter and decline for the next three quarters of the fiscal year. GII anticipates an 11.5 percent rise in oil prices for 2005; CBO projects a 17.5 percent rise in this volatile commodity. OMB, GII, and CBO each expect oil prices to decline during 2006.

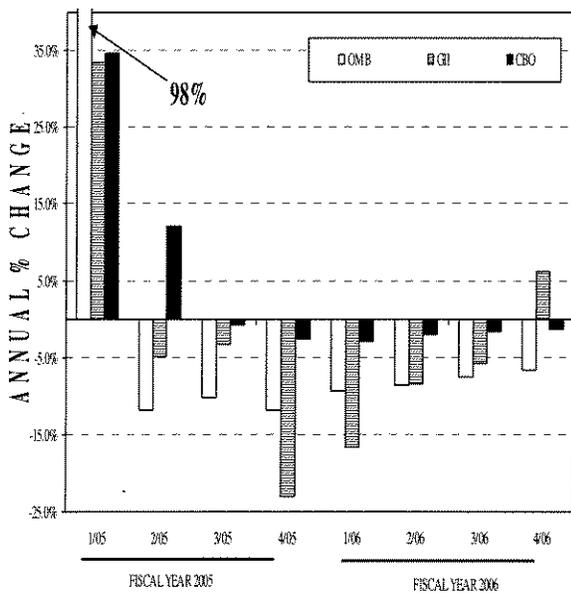
² The Bureau of Economic Analysis (BEA) released its revised estimates of GDP and other national income and product accounts on December 10, 2003. Quantities, or "real" measures, and prices were rebased to calendar year 2000.

U.S. SHORT-TERM ECONOMIC FORECASTS

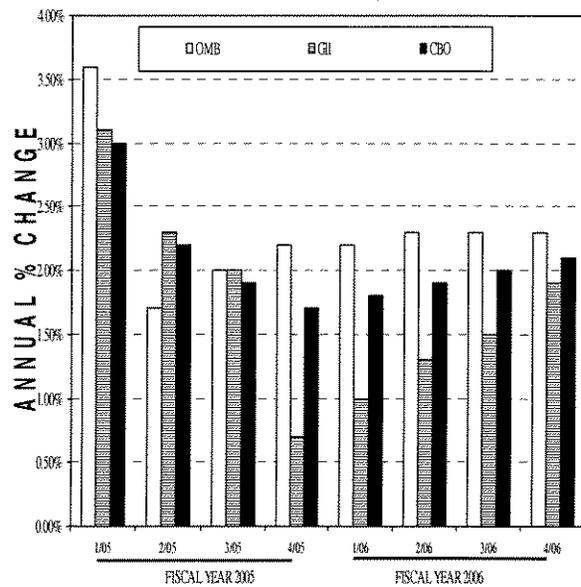
REAL GROSS DOMESTIC PRODUCT (1996 DOLLARS, CHAIN-WEIGHTED)



OIL AND GAS PRICE INDEX 1996=100

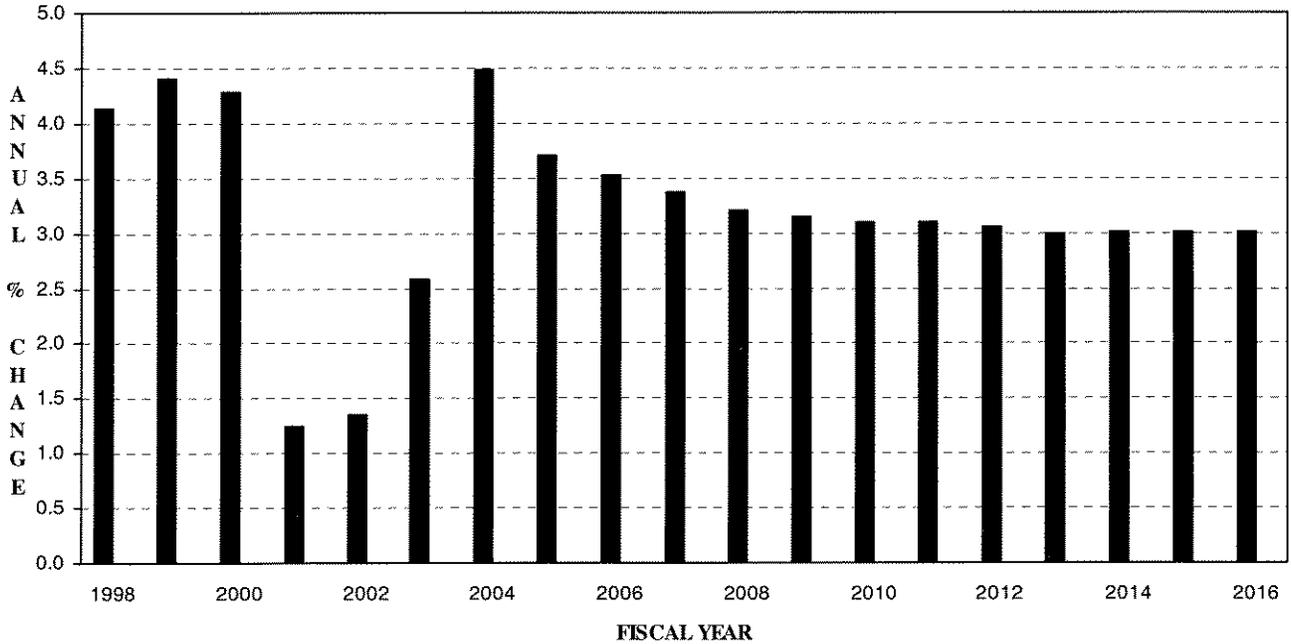


CONSUMER PRICE INDEX (1982-84 = 100)

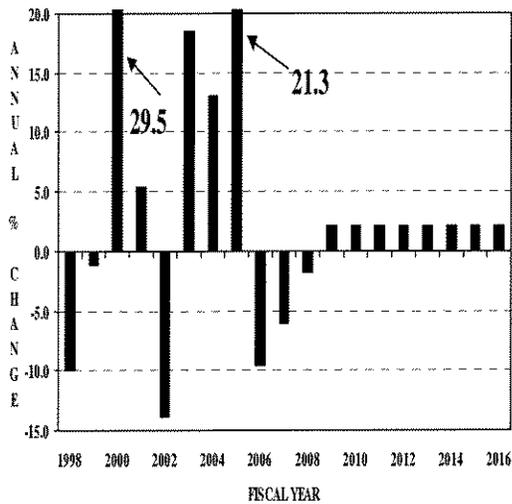


U.S. LONG-TERM ECONOMIC FORECASTS

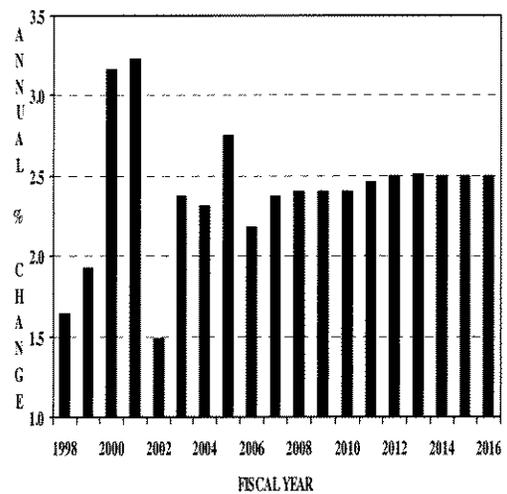
GROSS DOMESTIC PRODUCT (2000 DOLLARS, CHAIN-WEIGHTED)



OIL AND GAS PRICE INDEX
(2000 = 100)



CONSUMER PRICE INDEX
(1982-84=100)



LONG-TERM ECONOMIC OUTLOOK

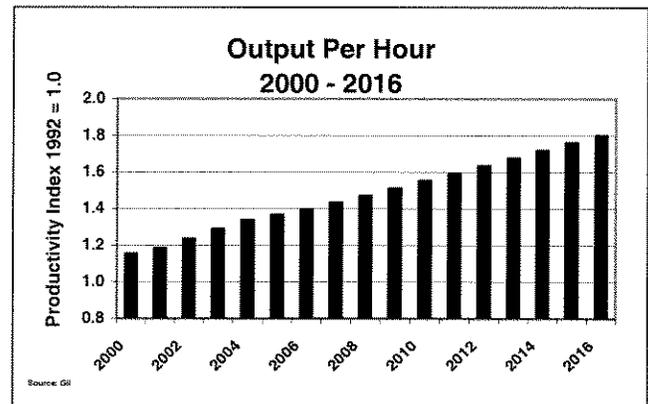
The long-term economic outlook for the U.S. economy shows real GDP growth averaging 3.2 percent over the 12-year forecast. (See graphics on page 6.) Long-term economic growth depends on growth in the workforce, production capital, and the technology that drives production. The size of the workforce depends on population growth, its composition, and the willingness to work. Capital accumulation depends on savings. Technology expands the productive power of labor and capital.

With the economic recovery well underway, the U.S. economy appears poised for relatively strong long-term income growth. While the labor supply will expand moderately during the forecast period, other factors such as low interest rates, continued capital investment, and productivity improvements from computers and the Internet will provide the fuel for a strong expansion.

The U.S. population is expected to expand at 0.9 percent annually over the forecast period according to GII. The U.S. labor force is projected to grow at the same pace over the period. Employment, based on the Bureau of Labor Statistics (BLS) establishment survey, is projected to increase 1.1 percent annually, from 131.2 million in 2004 to 150.0 million in 2016. Improved technology and more physical and human capital explain the increase in GDP over and above the growth in employment.

Continued growth in business investment over the forecast period implies further productivity increases. Therefore, wages will continue to rise over the forecast period. U.S. companies are projected to increase capital stock over the forecast period an average of 4.4 percent a year.

Productivity, as measured by output per hour, is forecast to rise 2.6 percent annually over the next 12 years. The following graph presents historical and forecast output per hour between 2000 and 2016.



Inflation is forecast to remain moderate during the forecast period with OMB projecting a 2.5 percent annual price increase through 2016. Fuel prices are forecast to rise by 21.3 percent in 2005, decline by 9.6 percent in 2006, and then increase at an average annual rate of 0.9 percent over the remainder of the forecast period. In real terms, oil prices are expected to decline at a 1.0 percent annual rate over the forecast period.

ALTERNATIVE FORECASTS

Alternative short-term U.S. economic forecasts are given in Chapter X, Table 1, as prepared by OMB, Global Insight, and CBO; Tables 2 and 3 present their long-term forecasts. Over the 12-year forecast period, both GII and CBO forecast long-term growth rates for the U.S. economy similar to OMB—up 3.2 and 3.0 percent, respectively. GII and CBO each expect prices to rise over the forecast period somewhat less than OMB, with forecasts of 2.3 and 2.2 percent, respectively. GII projects fuel prices to increase by only 0.5 percent over the 12-year forecast period, a third of the rate projected by OMB. CBO, on the other hand projects fuel prices to rise at 2.6 percent annually over the forecast period.

WORLD ECONOMIC OUTLOOK

The primary economic issues related to FAA's international traffic forecasts are discussed next. International economic data are presented in tabular form in Chapter X, Tables 4 through 6. GDP data are presented on a calendar year basis and are expressed in 2000 U.S. dollars. These data were obtained from GII.

WORLD GDP

The graphics on the following page depict both the historical trend and projected GDP growth for major economic regions of the world. Worldwide GDP is projected to increase by nearly \$1.1 trillion to a level of \$36.0 trillion in 2005, a 3.3 percent annual increase. Over the 12-year forecast period, world output is projected to reach \$50.8 trillion, an annual growth rate of 3.2 percent.

Canada

Canada had stronger growth than the United States in each year during 1999–2002, but fell behind in 2003 and 2004. Strong appreciation of the Canadian dollar has driven down the forecast for Canada's exports. Canada's GDP is projected to increase by 3.1 and 2.7 percent in 2005 and 2006, respectively. Remaining highly dependent on the U.S. trade, Canada's economy is projected to grow 2.8 percent a year over the forecast period.

Despite increases by the FED in recent months, interest rates remain higher in Canada than in the United States. The Canadian short-term rate averaged 2.3 percent in 2004 compared to the U.S. rate of 1.5 percent. The Canadian Central

Bank began its tightening cycle with a 25-basis-point increase September 8, and continued with another October 19.

Canada had both a fiscal surplus and a current account surplus last year, and should again this year and for several years to come. The prospects for significant debt and tax reduction at the federal level over the next several years have become brighter.

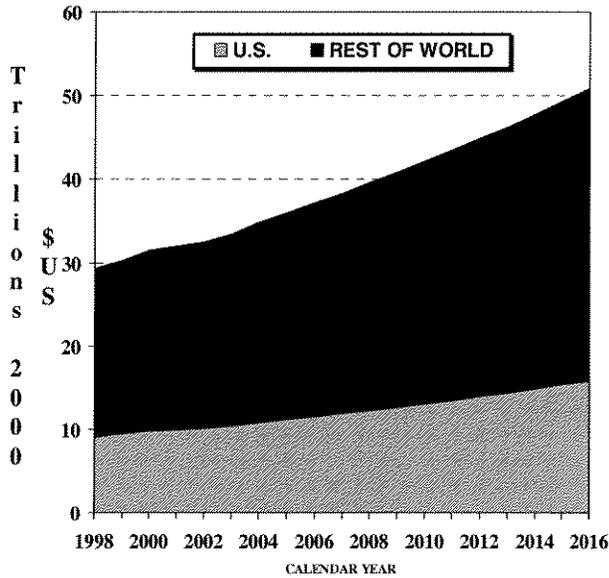
Canada's competitiveness will be challenged by the strength of its dollar now that it has climbed to the US\$0.80 level. As well, labor productivity has been much stronger in the United States than in Canada over the past year, which will likely continue to provide a competitive challenge for Canada.

There are two significant risks to Canadian economic growth over the forecast period: exchange rate appreciation makes it more difficult to sell Canadian goods abroad and the sustainability of the U.S. recovery. The Canadian dollar appreciated 12 percent in 2003 and 7.5 percent in 2004, and is forecasted to move up 7.8 percent in 2005. Over the remainder of the forecast period, the Canadian dollar is expected to rise about 0.7 percent annually. This appreciation will continue to make Canadian goods more expensive to U.S. citizens and companies.

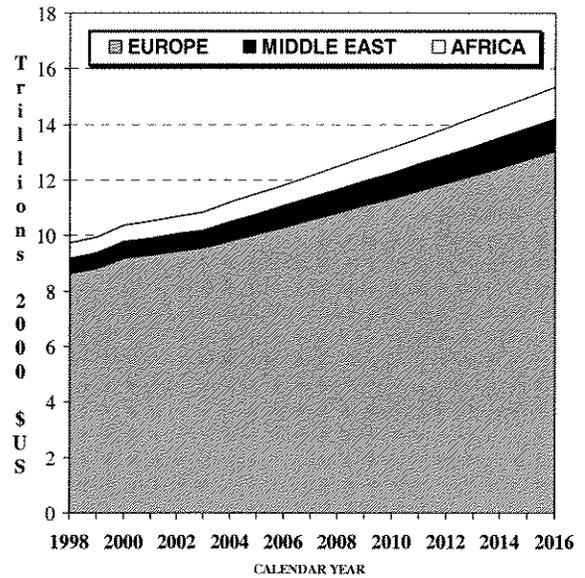
The U.S. recovery finally seems on solid footing. However, a faltering of the U.S. recovery would have a substantial impact on Canada. The importance of the U.S. economy to Canada is shown by the fact that 76 percent of Canadian total trade is with the U.S.

GROSS DOMESTIC PRODUCT BY WORLD REGION

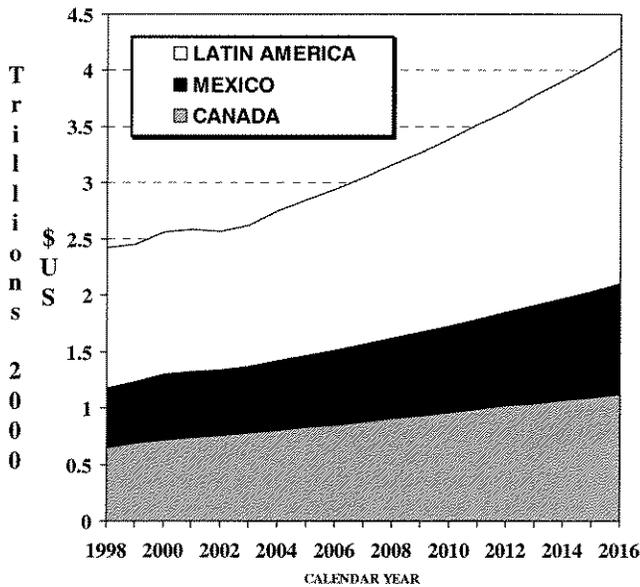
WORLD



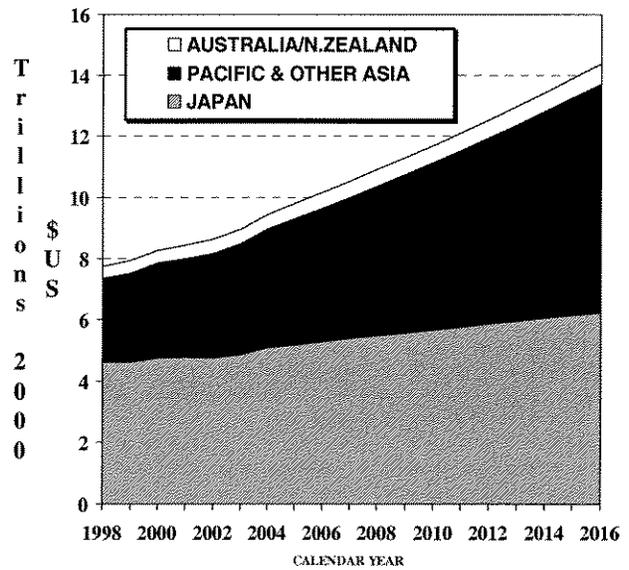
EUROPE/MIDDLE EAST/AFRICA



CANADA/MEXICO/LATIN AMERICA



JAPAN/PACIFIC & OTHER ASIA/AUSTRALIA & NEW ZEALAND



Pacific/Far East

The GDP of Asia and Oceania (Japan, the developing Asia Pacific, China, India, and Pakistan, along with Australia and New Zealand) grew by 5.2 percent in 2004, a significant gain relative to the 4.0 percent increase of a year earlier. GII projects Asian GDP growth to slow to 3.8 percent in both 2005 and 2006. Over the forecast period, the combined Asian GDP is projected to grow 3.6 percent annually, from \$9.4 to \$14.4 trillion.

The Asian economic machine is in high gear once more. However, growth in Asia is set to slow. And for some of the region's economies, the slowdown has already begun. Exports are expected to trend down, as growth in both the United States and China decelerate in 2005. Asian domestic demand still shows momentum and this will provide support as export growth slows. Record high oil prices have not yet been able to significantly slow Asia's growth momentum but cast a large shadow over the region's short-term growth prospects.

A combination of high oil prices and loose monetary policy has caused inflation to begin accelerating in parts of the region. Asian central banks are expected to begin measured monetary tightening. The deflation that has haunted much of Asia in the past few years has eased somewhat. However, falling prices remain a challenge in Hong Kong and Japan.

Japan's GDP, which makes up 54 percent of Asian economic output, grew by 4.1 percent in 2004, up from 2.5 percent growth in 2003 and the recessionary dip of -0.3 percent in 2002. The world's second largest economy is projected to grow by 2.0 and 2.1 percent, respectively, in 2005 and 2006. Over the forecast period, GII projects that Japan's GDP will expand by 1.7 percent annually.

The Japanese economy has shown some sluggishness recently, but the risk of a recession remains low. Exports and capital expenditures have flattened. The rise in oil prices has had little effect on the economy to this point. Most importantly, consumption continues to grow. Several factors support consumer spending: a stable labor market, high liquidity, and the perception that the most serious problems—recession and deflation—are unlikely to return. The uptrend in consumption as a share of the economy shows a resilient consumer market. Exports face a slightly higher risk. External demand has already flattened; and if the yen continues to appreciate exports will continue to become more costly, lowering their demand. Rising productivity will mitigate this trend.

Japan has instituted some banking and business practice reforms over the past few years. For instance, requiring greater transparency and more honest accounting from firms and allowing *de facto* bankrupt companies to be shut down. But major restructuring of the private sector has been slow. Japan remains overly dependent on exports to generate growth, and has only begun to locate plants offshore to produce goods for re-import back into Japan.

Also, the government's attempts to stimulate the economy have relied on massive public works spending. This has tended to prop up the construction industry, perhaps the most bloated and inefficient sector in the country. It also led to large budget deficits that have pushed government debt toward 160% of GDP.

The Pacific and developing Asia--the Pacific Basin, China, India, and Pakistan--continues strong and rapid growth. This set of countries grew at an average 6.6 percent during the 1990's. After a short slump in 2001 through 2003, this region grew by 6.9 percent in 2004. Developing Asia's economies are projected to climb 6.2 and 6.0 percent, respectively, in 2005 and 2006. Over the forecast period, GDP is forecast to rise by 5.6 percent annually.

China's output makes up approximately 16 percent of Asia's GDP and this share is projected to grow to 23 percent by the end of the forecast period. This rapidly growing economy expanded by 9.1 percent in 2004 and is forecast to grow 7.4 and 7.3 percent over the next 2 years. Over the next 12 years, China is forecast to grow by 6.8 percent annually.

Although China's economic prospects appear very bright, its future is laden with risk of both an economic and political nature. China has an enormous and inefficient state sector that requires reform.

Latin America

Mexico and Latin America have recovered from their economic slump during the early years of this decade. Mexico's GDP grew by 4.0 percent in 2004 after rising only 1.3 percent a year earlier; and Mexico is expected to continue its robust expansion at rates of 3.7 and 3.5 percent over the next 2 years. Over the forecast period, Mexico is forecast to grow at a 3.9 percent pace.

The countries of Latin America and the Caribbean, led by Brazil and Argentina, increased by 5.9 percent in 2004; a substantial improvement over last year's 1.5 percent growth and the 2.0 percent recessionary dip in 2002. Latin America is expected to grow by 3.7 percent in both 2005 and 2006. Over the forecast period, this region is projected to grow at 3.9 percent annually.

Mexico, a NAFTA partner with the U.S. and Canada, is heavily dependent on trade with the U.S. Eighty percent of Mexican exports go to the U.S. To the extent that the U.S. continues its strong recovery, this will keep Mexico on the upswing. The increase in world oil prices has substantially improved Mexican's fortune. However, the maquiladora-manufacturing sector has received considerable competition from

China. GII expects Mexican manufacturing exports to improve significantly in 2005 (up 11.3 percent) and to average 13.4 percent annually over the forecast period.

As in the past, Mexico's largest risk is its heavy dependency on trade with the U.S. Hence, the fate of the Mexican economy lies in the performance of the U.S. economy. Another risk is the price of oil. A rapid decline in the price of oil would substantially impair Mexico's economic growth.

Latin America's largest economy, Brazil recovered strongly from the 2003 recession (down 0.2 percent), expanding by 4.3 percent in 2004. GII projects Brazil to continue its recovery with growth of 3.8 and 3.6 percent in the next 2 years. The long-term growth target for Brazil is 4.0 percent.

Argentina is in the second year of its recovery after a deep (10.9 percent) recession in 2002. The economy grew by 6.2 percent in 2004 and is expected to grow by 2.7 and 2.8 percent over the next 2 years. Over the next 12 years, growth will average 3.4 percent. Much of the high risks of inflation and high government spending in Argentina appear to be past.

Europe/Middle East/Africa

The combined economic output of all Europe, the Middle East, and Africa make up a third of the world's economy. This region grew by 3.0 percent in 2004, doubling the 1.5 percent growth of a year ago. This European dominated region is forecast to grow by 2.8 percent annually over the next 2 years. Over the 12-year forecast period, this region is expected to grow 2.7 percent a year.

Western Europe, responsible for 81 percent of the region's output, grew by only 2.4 percent in 2004. The European Union (EU), made up of

25 countries but dominated by Germany, France, Italy, and the United Kingdom, makes up the bulk of this region. This region is forecast to increase by 2.1 and 2.3 percent in 2005 and 2006, respectively. Over the forecast period, Western Europe is projected to grow 2.2 percent annually.

Germany, the largest economy in Western Europe has several economic burdens to tackle. Among its disadvantages are high labor costs, rigid labor market regulations, a complex tax system with relatively high corporate and income tax rates, a large public sector, and a costly “pay-as-you-go” pensions system that will come under increasing pressure from an aging population. Germany is expected to grow an anemic 1.7 percent over the forecast period.

The UK, EU’s second largest economy grew by a healthy 3.2 percent in 2004 and is expected to grow 2.6 and 2.4 percent over the next 2 years. Over the forecast period, growth will average 2.5 percent. The United Kingdom is the only large European economy not included in the European Monetary Union (EMU). The U.K. is not opposed to participation in principle and is expected to become a member once it has met the appropriate criteria. However, when the decision is finally made to join the single currency, the U.K. could experience undue inflationary pressures if the entry level is too low or a reduction in exports is too high.

Emerging Europe, which includes the countries of Eastern Europe and former Soviet Republics, expanded its combined GDP by 7.1 percent in 2004. This flourishing region is projected to grow 5.9 and 5.4 percent in 2005 and 2006. In the next 12 years, this region’s GDP is projected to grow 4.6 percent a year.

Relatively low wage rates have fueled the region’s growth in exports and consequently economic growth. Economic risks in this region relate to overly expansionary fiscal policies of many of the countries, the slower-than-expected restructuring of heavy industries,

and largely un-restructured agricultural sectors, mainly in Poland, Romania, and Turkey.

The oil and commodity exporting regions of the Middle East grew 7.0 percent in 2004. This region is forecast to grow 6.9 and 5.0 percent over the next 2 years. Over the forecast period this region is projected to grow 4.3 percent.

DOLLAR EXCHANGE RATE

Graphics on the following page present historical and forecast values for the U.S. trade-weighted nominal exchange rate index with selected other developed countries.³ The trade-weighted exchange rate measures the relative purchasing power of the U.S. dollar against other developed countries and accounts for trade differences. The graph also displays the historical and projected dollar exchange rates against the Japanese yen and the European euro. Table 6 in Chapter X displays the historical and forecast exchange rates from 1998 to 2016 for the Canadian dollar, the British pound, the Japanese yen, and the European euro.

The U.S. dollar on trade-weighted terms continued to fall against its major trading partners in 2004. The dollar is forecast to continue to decline against trading partner’s currencies through the end of the first decade of this century and then appreciate for the remainder of the forecast period. On average, the dollar will decline 0.1 percent annually.

The U.S. dollar continued to fall against the Canadian dollar in 2004 to the point that a Canadian dollar cost \$0.767 compared with \$0.714 a year earlier—a 7.4 percent decrease in the value of the U.S. dollar. The appreciation of

³ Note: A fall in the index implies a depreciation of the dollar against other currencies; a rise in the Euro and yen also implies a depreciation of the dollar.

the Canadian dollar is expected to continue, increasing to \$0.883 by 2016.

The Japanese yen too continued to appreciate against the dollar in 2004, rising 6.8 percent to \$9.21 per ¥1,000. Over the forecast period the yen is forecast to rise by an average of 2.0 percent per year, reaching \$11.72 per ¥1,000 in 2016. The euro continued its strong gains against the dollar with a 9.6 percent gain in 2004 following a 19.6 percent rise in 2003. Over the next 12 years, the euro is projected to continue to rise 0.9 percent a year to 1.38 to the dollar in 2016.

U.S. REGIONAL ECONOMIC GROWTH

Although growth is well underway, the strength of regional economies varies substantially. Two regions are clearly growing more rapidly than others--Mountain and South Atlantic--with employment growth of 2.1 and 1.9 percent annually. The New England region is expected to grow slowest at just under 1.0 percent.

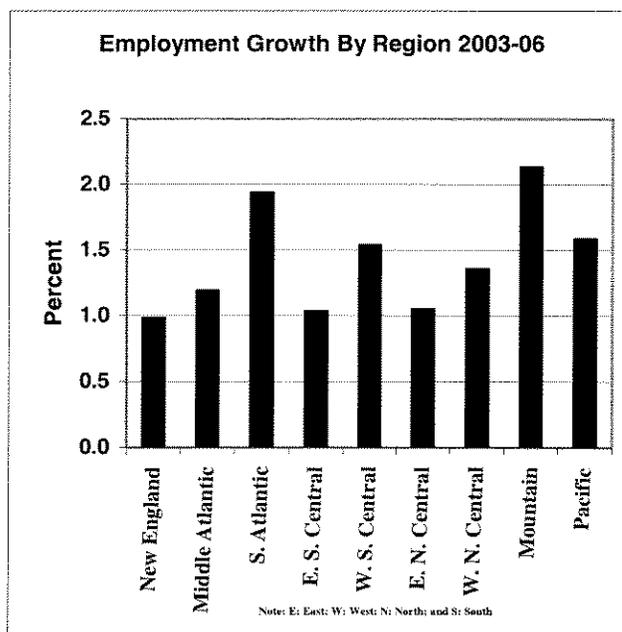
The chart below shows GII's forecast for employment growth by region for 2003 to 2006. Each region has its own character and faces its own challenges. The South Atlantic--Delaware, Florida, Georgia, Maryland, North and South Carolina, Virginia, and West Virginia--shows relatively strong growth.

Part of the region's economic strength lies in its most southern state--Florida's economy is one of the hottest in the nation. Florida's tourism industry continues its recovery, with visitor levels in the second quarter of 2004 up 3.8 percent from a year earlier. Hotel occupancy rates have also continued to rise in all major markets, although remaining below their late-1990s peak. Virginia is another of the region's fast growing states, its growth driven primarily

by the technical and service industries in northern Virginia.

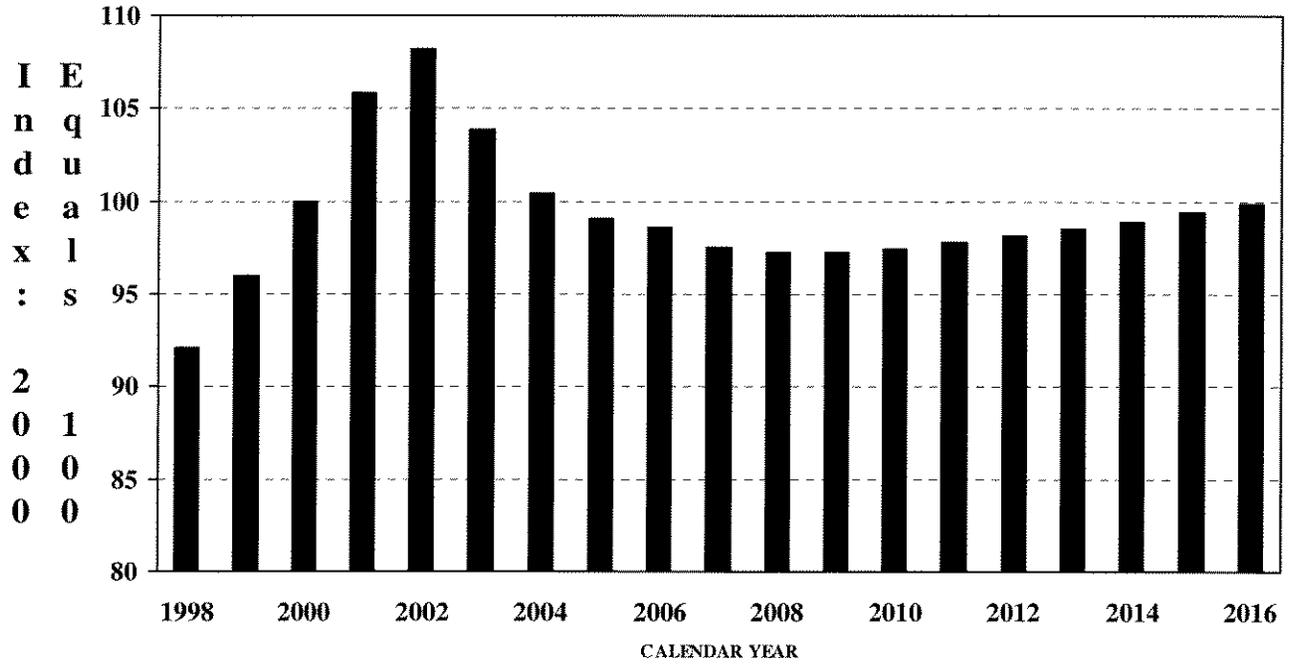
Florida's red-hot economy was stymied momentarily by the four hurricanes the swept through the state during August and September (Charley, Frances, Ivan, and Jeanne). Economic loss is estimated at about \$20 billion. In the short-term, the two primary effects in the aftermath of these storms are the displacement of so many families (18,500 houses destroyed and 37,000 with major structural damage) and the expected boom in the construction industry. The construction industry in Florida is expected to hire an additional 5,000 workers in the fall of 2004 through 2005. Long-run growth in this dynamic state economy is unlikely to be affected by the storms.

The Mountain region, including Arizona, New Mexico, Colorado, Nevada, Montana, Idaho, and Utah, is the second fastest in terms of growth. The best-performing sector in the region was professional and business services, which expanded 4.7 percent in 2004. Idaho, New Mexico, and Utah led the way in this sector, up 8.0, 7.2, and 7.2 percent, respectively.

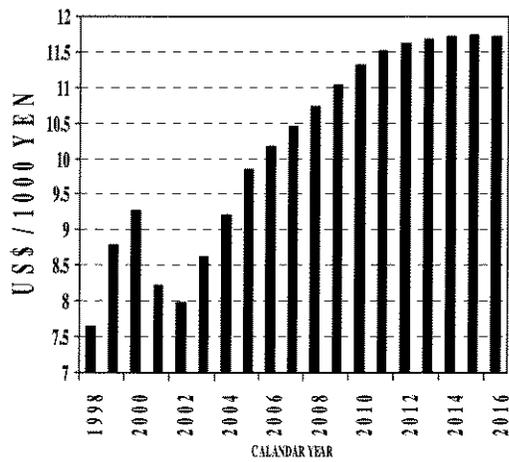


EXCHANGE RATE TRENDS AND FORECASTS

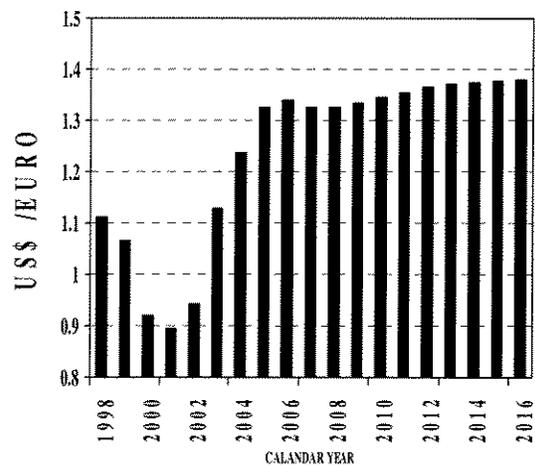
U.S. TRADE-WEIGHTED EXCHANGE RATE (NOMINAL RATE WITH OECD COUNTRIES)



JAPANESE YEN



EUROPEAN UNION EURO



The New England Region—Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut--has weathered a succession of layoffs and mergers during the past few years. However, the region's financial services sector should begin to recover during the coming year. In particular, recent news shows that the Bank of America is moving around 100 jobs to Boston and locating a call center in Rhode Island, creating nearly 900 jobs.

The following table shows the 10 fastest growing metropolitan areas ranked by annual employment growth from 2003 to 2006. Las Vegas continues to lead the list. This gaming center offers a leading tourist destination as well as a rapidly growing retirement community. All but one of the cities on this list is in the four Sunbelt states: Florida (3), Nevada (2), California (1), Arkansas (1), and Arizona (1). The one exception is Boise, Idaho. The recent boom in high-tech employment prompted many manufacturing firms to relocate to Idaho, in part to take advantage of the state's favorable business climate.

TOP 10 METROPOLITAN AREAS IN EMPLOYMENT GROWTH 2003 – 06		
Metropolitan Area	2003 Employment (000s)	2003-06 Growth (%)
Las Vegas, NV	820.1	4.2
Boise City, ID	229.1	3.0
McAllen, TX	175.2	3.0
Fayetteville, AR	172.2	2.7
Reno, NV	199.8	2.6
Orlando, FL	925.7	2.6
Riverside, CA	1087.7	2.4
West Palm Beach, FL	527.5	2.4
Sarasota, FL	283.5	2.4
Phoenix, AZ	1616.7	2.4

RISKS TO THE FORECAST

The U.S. and world economic growth appears stable and positive at this time. The recessionary period during the early years of the decade appears over. However, important economic and terrorist related threats remain. Both the U.S. and world economic forecasts face substantial risks.

The U.S. economy may be in for a soft patch as the leading indicators have fallen for 5 consecutive months. Consumer spending growth is at its weakest rate since the 2001 recession. Higher oil prices are expected to take a bigger bite out of the consumer dollar. The cumulative effect of these risks could reduce U.S. economic growth substantially.

Although worldwide risks are substantially lower than they were at the beginning of the Iraq conflict, important risks remain for the world economy. A major reason for the currently high global risk levels is the super-stimulative monetary and fiscal policies of the authorities in industrialized countries and Asia, which have boosted debt-to-GDP ratios across the globe and created potentially dangerous economic imbalances and asset bubbles.

Most regions of the world have seen debt levels rise over the past decade. In the developed world and, more recently, in Asia, both the private and the public sector have contributed to this rise. In the rest of the emerging markets, the growth in debt has been exclusively a public-sector phenomenon. While higher debt levels do not pose a large threat to the current global recovery, they heighten the vulnerability of the world economy to future increases in interest rates and could exacerbate the next global downturn.

Although the outlook for oil prices appears sanguine at this time, a spike in oil prices is

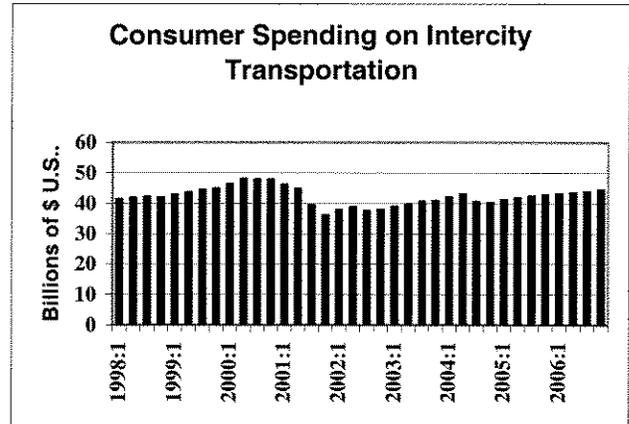
possible. A shortage of one or two million barrels of OPEC oil would boost oil prices by as much as \$10–20 per barrel and lower world GDP growth by roughly 0.5–1.0%, but would be unlikely to cause a global recession. In fact, the more dynamic regions of the world economy (such as Asia-Pacific) should be able to weather even a \$20 spike in oil prices.

This possibility arises from the uncertain political situations of many of the major oil exporters, such as Saudi Arabia, Nigeria, Venezuela, Iran, Iraq, Algeria, Libya, and Angola. Fortunately, the global economy’s momentum is strong enough that it should be able to cope with most likely disruptions. Although an oil price spike would reduce global GDP, it is unlikely to cause a global recession.

SUMMARY AND IMPACT ON AVIATION

The recovery in the travel industry is moving along despite a brief lull in expenditures during mid-2004. Expenditures on intercity travel slipped a bit in the third and fourth quarters of 2004 but are expected to resume growing in

2005. The following chart shows expenditures on intercity travel in the U.S. from the first quarter 1998 to the projected fourth quarter 2005. Although the rise in expenditures on city-to-city travel will continue in 2005, expenditures will reach their 2000 levels sometime beyond 2006.



The aviation industry continues to face risks beyond those faced by most other industries. Although the FAA expects traffic to improve substantially in the near-term, airline finances remain at risk. The legacy carriers continue to struggle toward profitability. As the low-cost carriers, which now carry about a quarter of U.S. airline passengers, continue to gain market share, profitability by the legacy carriers will remain difficult.