

August 18, 2005

TO: CARLI Board of Directors

FROM: J. David Stewart
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SUBJECT: Economic and Budget Update Report

The following information has been compiled from multiple published sources and is intended to provide an update on the national and state economy, the Illinois revenue forecasts and status of FY 2006 state budget.

National Economy

At this time, the national economy continues to show generally positive trends, but there are some underlying concerns as illustrated by some of the most recent economic data available.

- Short term interest rates continue to rise as the Federal Reserve moves to counter inflationary concerns by raising rates a tenth time recently by another .25%. Federal funds rates at 3.5% are now at their highest level in 4 years. These baseline short-term interest rate changes affect prime interest rates, mortgage and revolving credit card rates, ARMS and other variable rate types of interest adjusted debt.
- Trade deficits remain at record levels, jumping by more than 6.1% in June alone to over \$55.8 billion.
- Crude oil and gasoline prices are above \$66 per barrel and approaching \$3 gallon, respectively. This affects both consumers directly and indirectly through higher transportation costs and surcharges paid.
- Wholesale inflation increased by the largest amount in nine months during July—largely due to fuel cost increases. Core inflation rates at the retail level increased more moderately.
- Predictions in the agricultural sector show estimated yields for corn and soybean crops to be significantly smaller (by as much as 25 percent lower) than last year due to drought conditions.
- Consumer spending in retail sales and durables such as new automobiles remained strong
- Unemployment claims nationally have been dropping, and the economy has added 207,000 more new jobs in July.

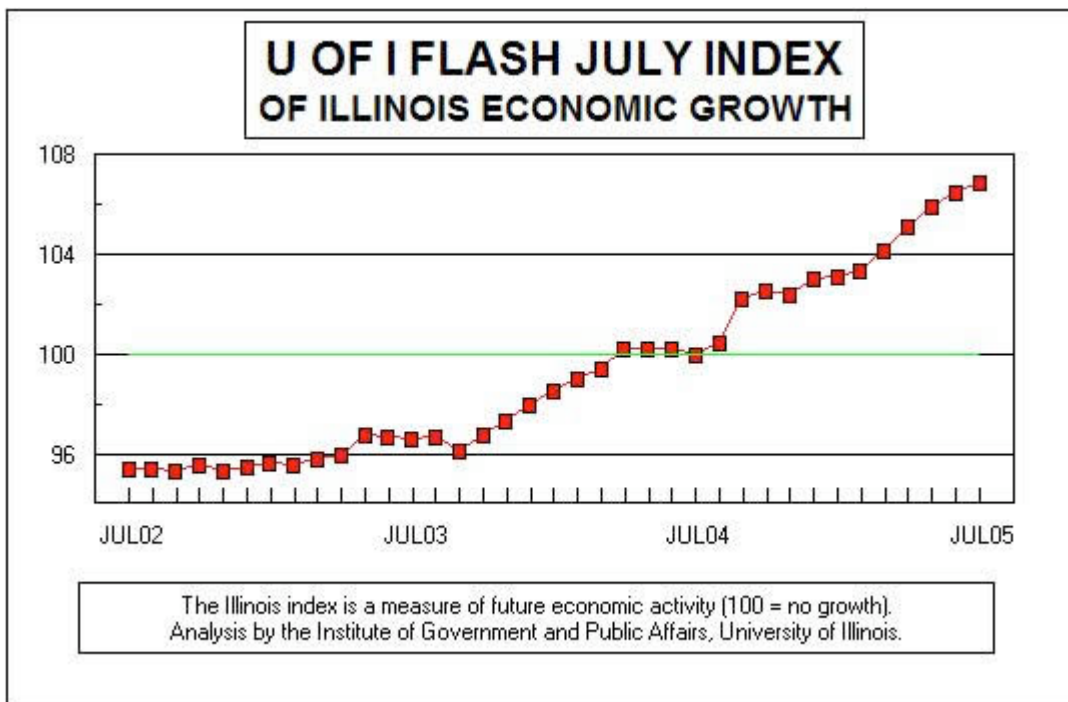
Illinois Economy

In general, the Illinois economy is showing marked and steady improvement. Real economic indicators point to solid progress in economic recovery: building permits are up from last year and the most recent 4 month average shows them to be up by over 12% over the comparable period last year. Illinois' new claims for unemployment compensation are down; hours worked in manufacturing are improving; receipts from personal income tax, corporate income tax and state sales tax are also improving.

The University of Illinois Flash Economic Index continued its strong performance, rising to 106.9 in July from its 106.5 level in June. Just a year ago, the Index was at 100, the threshold between economic growth and decline. In July, all components of the Index were up in "real" (inflation-adjusted) terms from the same month a year ago. It now stands at the highest level since May 1998.

J. Fred Giertz, the Illinois economist who compiled the data stated: "Despite this good news, the Illinois economy still has not closed the gap with the rest of the nation after a very sluggish recovery from the 2001 recession. Last year, for example, the state's per capita income was only 104 percent of the national average, which is the lowest level since records have been kept."

The Flash Index is a weighted average of Illinois growth rates in corporate earnings, consumer spending and personal income. Tax receipts from corporate income, personal income and retail sales are adjusted for inflation before growth rates are calculated. The growth rate for each component is then calculated for the 12-month period using data through July 31.



State Revenues

The Illinois State Comptroller, Daniel Hynes, issued a quarterly update (Edition 15, July 2005) indicating that while FY 2005 revenues reflected stronger economic performance, the base revenues after considering short term borrowing and transfers decreased by \$663 million or 2.5%. This expected decline in revenues is due to a reduced reliance on one-time sources of revenue (e.g., certain federal program fund reimbursements such as Medicaid, tax amnesty program, state pension obligation bond proceeds). The good news is that with the strengthening state economy, income and sales taxes easily exceeded the revenue projections of most state forecasters. In FY 2005, individual income tax yields were up \$707 million or 9.7%, corporate income tax receipts increased by \$236 million or 25.2%, and state sales taxes grew by 4.2% or \$264 million over the previous year.

As of June 30, 2005, the state General Funds end-of-year available balance stood at \$497 million, reflecting an increase of \$315 million over the previous year. Despite this generally favorable news, it is important to consider revenues in relation to expenditure levels and forecasts of what lies ahead. Although State revenues are strengthening, the growing demand for State resources has increased even faster. For example a health care provider backlog, federal matches on the transportation bill, Medicaid, state health and other employee benefit programs, debt service on state-issued bonds, and stabilizing state pension systems will strain the state's ability to avoid deficits even with improved economic conditions and improved revenue growth in the future. This leaves virtually no flexibility to cope with the need for increased investments in state services, education funding, social services, capital improvement program needs, or to meet the uncertainty of future downturns in the national and state economy.

There is also a backlog of unpaid state bills on hand that totaled \$405 million—and these unpaid bills are in addition to those normally carried over and paid during the state's 60 day lapse period after June 30, 2005. As Comptroller Hynes indicates in his report, these expenditures “are expected to create significant cash management challenges for the state for the first quarter of fiscal year 2006 and beyond.” Comptroller Hynes also noted that “in or near the first quarter of each of the past three fiscal years...the state has borrowed funds on a short-term basis to provide liquidity to the General Funds when a combination of lapse period spending and Medicaid needs have historically exceeded available revenues.”

Please let me know if you have any questions.