

November 15, 2005

TO: CARLI Board of Directors via CARLI Finance Committee

FROM: J. David Stewart
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SUBJECT: Economic and Budget Update Report (Informational Item)

The following information has been compiled from multiple published sources and is intended to provide an update on the national and state economy, the latest available 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.

- The U.S. trade deficit posted a record high in September 2005: the deficit jumped to \$66.1 billion or 11.2 percent higher than the \$59.3 billion imbalance recorded in August 2005. In part, this reflects the price hikes in imported oil supplies and a big increase in consumer goods imports (clothing, toys, and electronics).
- U.S. claims for unemployment benefits fell by 8,000 to 323,000 for the week ending October 29th—comparable to pre-Hurricane Katrina levels.
- Reported U.S. oil company profits have been huge by any reasonable standard of measurement. Together, the major companies earned more than \$25 billion in profits for a single quarter from July-September 2005 as the price of crude oil hovered around \$70 per barrel. Supply disruptions due to the hurricane-caused closure of transportation routes and refineries in the Gulf region were cited by oil company executives for the higher oil and gasoline prices paid by consumers at the pump.
- The Consumer Confidence Index continued the decline that began in September. The Conference Board reported that the Index dropped from 87.5 in September to 85.0 for October.
- The Gross Domestic Product (GDP) increased by 3.8% in the third quarter of 2005, exceeding the 3.6% growth rate that many analysts had predicted. The GDP growth rate of 3.8% was an improvement over the 3.3% rate for the second quarter of 2005.

- U.S. auto sales fell sharply in October as a result of the hurricanes and increased gas prices. Automakers warned that this trend could continue during November.
- Short term interest rates increased from 3.75% to 4%. Federal funds rates of 4% are at their highest level in more than 4 years. According to Alan Greenspan, Federal Reserve Chairman, “Structural productivity continues to grow at a firm pace and rebuilding activity following the hurricanes should boost real GDP growth for a while. More uncertainty however surrounds the outlook for inflation.” 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.
- The Chicago Fed National Activity Index (CFNAI) indicated economic growth below trend for September. Two of the four broad categories of indicators that make up the index (employment and production) accounted for much of the decrease. The CFNAI is a weighted average of 85 monthly indicators designed to better gauge national economic activity and inflationary pressure.
- The U.S. Department of energy reported that consumer fuel prices continued to drop. A report dated October 31 indicated that gasoline prices had decreased by 12.3% in just one week, and diesel fuel decreased by 28.1% in that same time frame. But those prices are still higher than a year ago, with gasoline prices up 44.6% compared to last October, and diesel up 67%.
- Consumer prices, as reflected by the Consumer Price Index (CPI) increased by 1.2% in September, up from a 0.5% increase in August 2005, with most of the increase attributed to the increase in fuel/energy costs. The Bureau of Labor Statistics (BLS) reported that employment was little changed (+56,000) in October, and the unemployment rate was essentially unchanged at 5.0 percent

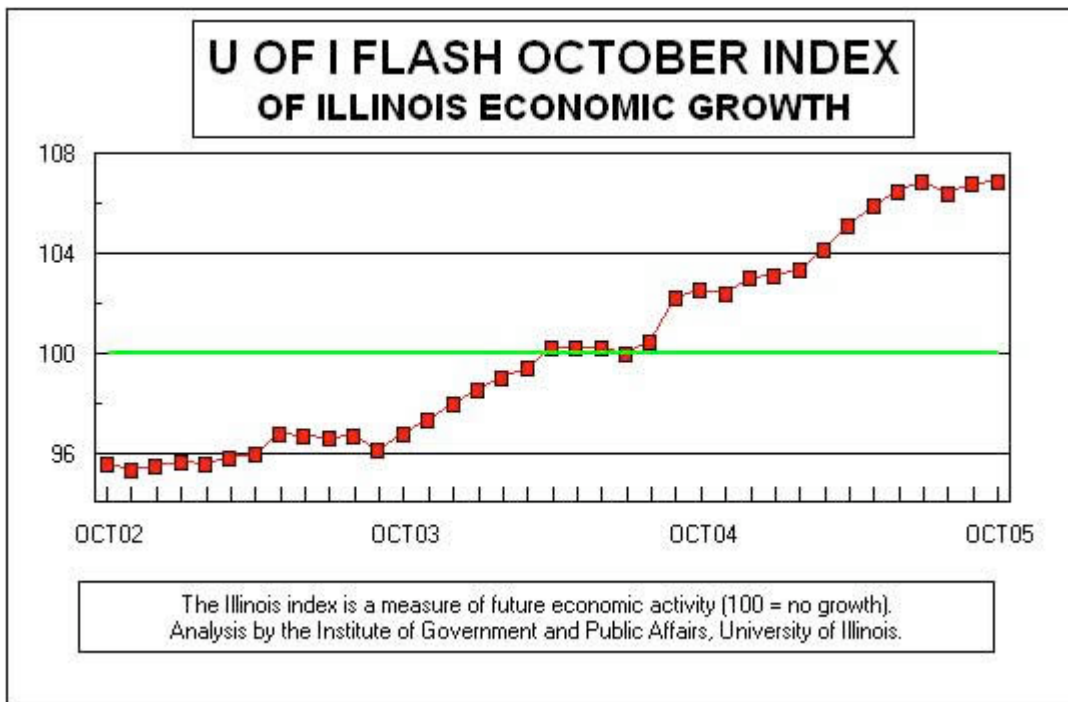
The Commerce Department reported that U.S. housing starts increased in September by 3.4%, and permits for new housing jumped by 2.4% to reach the highest rate since February 1973. The future picture for housing, however, is a bit more mixed: a softening of the real estate market, gradually rising mortgage interest rates, and concerns about weaker consumer spending and inflation make economists wary that the inflated values in the housing bubble may begin to burst. In addition, recent administration debates about the possible loss of the popular personal income tax write-offs for mortgage interest deduction has just added to these concerns about the future of the U.S. housing market.

- Productivity growth has slowed, increasing at an annual rate of 1.8% in the April-June quarter, down from a 3.2% increase in the first three months of the year. The 1.8% increase was the slowest increase since the summer of 2004. The BLS reported that productivity for the third quarter increased 4.8 percent in the business sector, as output grew 4.3 percent and hours declined 0.4 percent. In manufacturing, productivity increases in the third quarter were:
 - 4.5 percent in manufacturing,
 - 7.5 percent in durable goods manufacturing, and
 - 1.7 percent in nondurable goods manufacturing.

Illinois Economy

In general, the Illinois economy is showing steady improvement, although at a slower rate than in the recent past. Real economic indicators point to solid progress in economic recovery.

The University of Illinois Flash Economic Index remained at 106.9 last month, the same level as September. According to University of Illinois economist J. Fred Giertz. “A stable Index means that the state economy continues to expand at the same rate, which is positive news since the Flash reading is at the highest level since January 1998.” Giertz added that the October reading confirms that the hurricanes and floods in the South have caused minimal damage to the Illinois economy. All three components of the Flash Index were up in real (inflation-adjusted) terms in October from the same month a year ago. Corporate receipts were especially strong last month. 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 October 31.



There are some lingering concerns about the near term outlook for the Illinois economy and about particular sectors. First, in advance of the new federal bankruptcy reform legislation, consumer personal bankruptcy filings in central Illinois spiked to more than 5 times the level in the previous year. The domestic automotive industry (particularly Ford and GM) and plants manufacturing parts or assembling vehicles are under severe economic stress. Similarly, the domestic airline industry, which has a strong presence in Illinois at Chicago O’Hare airport, has experienced corporate bankruptcy reorganization filings, layoffs, significant cost reduction measures, and faced rapidly escalating jet fuel prices. For example, United Airlines (based in Elk Grove, IL) posted a record third quarter loss of \$1.77 billion. All of the major carriers are

experiencing similar economic difficulties. Insurance companies based in Illinois are facing major casualty losses due to Hurricane Katrina and other recent hurricanes. Allstate Insurance (based in Northbrook, IL) experienced a third quarter operating loss of \$1.55 billion.

While the national and state economies continue to expand, and revenues from traditional state tax sources are reasonably strong, the revenue growth remains insufficient to meet core state expenditure requirements—driven largely by increases in Medicaid and related health care costs. The Illinois Treasurer and Comptroller have approved the Governor's request to undertake short term borrowing of over \$1 billion to pay off the backlog of accumulated bills due to Medicaid providers. The available cash balance in the state's general funds is clearly insufficient to cover these obligations and further payment delays would only serve to increase the interest costs that the state would have to pay to vendors on these unpaid bills.

We will continue to monitor the state economic and budget condition closely, and will evaluate the performance of the Illinois economy at mid-year after second quarter FY 2006 actual revenues are recorded by mid January 2006. Please let me know if you have any questions.