

December 14, 2005

TO: CARLI Board of Directors via CARLI Finance Committee

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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 and clearly mixed signals, as illustrated by some of the most recent economic data available.

- ⌚ The national economy grew in the GDP by 4.3% in the third quarter, reflecting the best showing in more than a year. Brisk spending by consumers and businesses and a strong housing sector contributed to these gains. Businesses have boosted spending and investment in equipment, software and facilities. The pattern of investment by sector has been uneven—with domestic automobile manufacturers, domestic airlines, and pharmaceutical companies showing signs of economic stress, plant closures, and layoffs (e.g. General Motors, Ford, Delta Airline, and Merck.)
- ⌚ The U. S. international trade deficit soared unexpectedly to a record \$68.9 billion in October (latest data available), despite a drop in the cost of imported oil. Imports of goods and services increased by 2.7 per cent to a record \$176.4 billion. The deficits were most notable in establishing new record levels with China, Canada, Mexico, OPEC and European Union.
- ⌚ The hurricane-related jobless claims rose to 599,700 in early December, as the labor market in the Gulf Coast region makes a slow economic recovery. The rate of unemployment claims has been slowing in recent weeks, but is still significant for the region. Offsetting this news somewhat, the US Labor Department reported that 215,000 new workers were hired in the month of November across the nation. The big jump in employment levels has kept the overall jobless rate at 5% nationally in November. Still, there were reported plans of major job cutbacks and plant closings at GM, Ford, Merck and other major companies.

- ⌚ Housing market activity and values show a definite slowdown—concerns about rising interest rates, inflation (particularly higher home heating/energy) costs and consumer discretionary spending were cited as factors.
- ⌚ Orders to U.S. factories increased at a healthy pace in October with third quarter worker productivity increasing (at an annual rate of 4.7%) by the largest amount in two years. Despite productivity gains, income growth has lagged for middle and low-income workers reflecting increased competition from foreign workers in low-wage countries. This is reflected in the record level U. S. trade deficits.
- ⌚ Manufacturing activity grew at a slightly slower pace in October as companies felt the strain of increasing energy and raw material prices. The Institute for Supply Management stated that its manufacturing index was 59.1 in October, down from September's 59.4 level. Any index reading above 50 indicates that the sector is expanding, while values below 50 indicate contraction in manufacturing activity. Rising energy prices continue to be of major concern, as manufacturers struggle to control costs.
- ⌚ Consumer confidence soared in November: the index value jumped 13 points higher than October—reflecting lower gasoline prices, and some gains in the job market. It should be noted that the current index level is still below the pre-hurricane levels and that higher interest rates and expected significant higher natural gas and other fuel costs for winter home heating may dampen consumer confidence in the coming months.
- ⌚ National retail sales posted a moderate increase in November, buoyed by strong retailer holiday discounts and promotions and demand at building supply centers as the victims of the Gulf Coast hurricanes begin to undertake repairs on their severely damaged homes. The final holiday sales figures are not available but there is some speculation of mixed results: consumer spending seems to be limited, stimulated only by deep retail discounts, promotions, and perceived bargains. In fact, retail sales for November were up only 0.3 percent in November, slightly below the 0.4% forecasted increase. Retailers are hoping that rising consumer confidence, stimulated by a rebound in job growth and lower gasoline prices, will boost sales in the closing days of the holiday shopping season. Offsetting these positives, are concerns about rising consumer credit card interest rates, high existing consumer debt levels, dampening of housing values tied to home equity loans and lines of credit, and higher home heating costs (natural gas and fuel oil) in the winter season.
- ⌚ Not all of the economic news can be considered good. Most hourly workers have observed that their paychecks are not keeping up with general inflation. Over the last year, hourly wages are up only 2.9 percent while inflation is running at about 4.7 percent. Many employers are contemplating cutbacks in benefits such as pension plans and health care cost-sharing arrangements with their employees.
- ⌚ The federal government has dropped its earlier prediction that oil prices will drop and stabilize to a level of \$30 per barrel. Analysts now believe that oil prices are likely to remain higher—in the range of \$50 per barrel over the next several years. The U. S. Energy Department had a more positive prediction on natural gas prices--a retreat from the recent 14 per thousand cubic feet down to \$5 as long-term demand weakens. In the near term, however, natural gas prices this winter heating season are expected to be nearly double or even more that of last year.

- ⌚ Forecasted payroll job levels are expected to show a growth of more than 200,000-215,000 for November. This was due to the fact that energy prices have fallen slightly and the hurricanes temporarily depressed employment levels.
- ⌚ The Federal Reserve lifted interest rates by a quarter point to 4.25% for the 13<sup>th</sup> time to the highest level in 4 1/2 years this past week. By contrast, the fed funds rate in June of 2004 stood at a 46- year low of only 1 percent. The federal funds rate represents the cost of funds banks charge each other on overnight loans. In response to the fed rate increase, commercial banks began increasing their prime lending rate to 7.25%, also the highest level recorded in 4 ½ years. This will have a ripple effect on certain credit card rates, ARM's, home equity lines of credit, and other interest-sensitive or adjustable rates.

### **Illinois Economy**

The University of Illinois Flash Economic Index fell slightly in its rate of growth in November, to 106.4, from its 106.9 level in October. Since the Index remains well above 100, the break-even point between growth and contraction, the state economy continues to expand at a robust rate.

The Index has been above 106 for six months. "This is consistent with sustained strong economic growth that might be expected at this stage of the business cycle," according to J. Fred Giertz, the University of Illinois economist who released the data. He noted that November marks four years since the end of the 2001 national recession. "Since 1980, expansions have lasted about 10 years. If this pattern continues, the state and nation can expect several more years of expansion," he said.

The recent monthly index values have not been at this level for a sustained period of time (since 1998), although the rate of growth in the last 6 months has slowed somewhat.

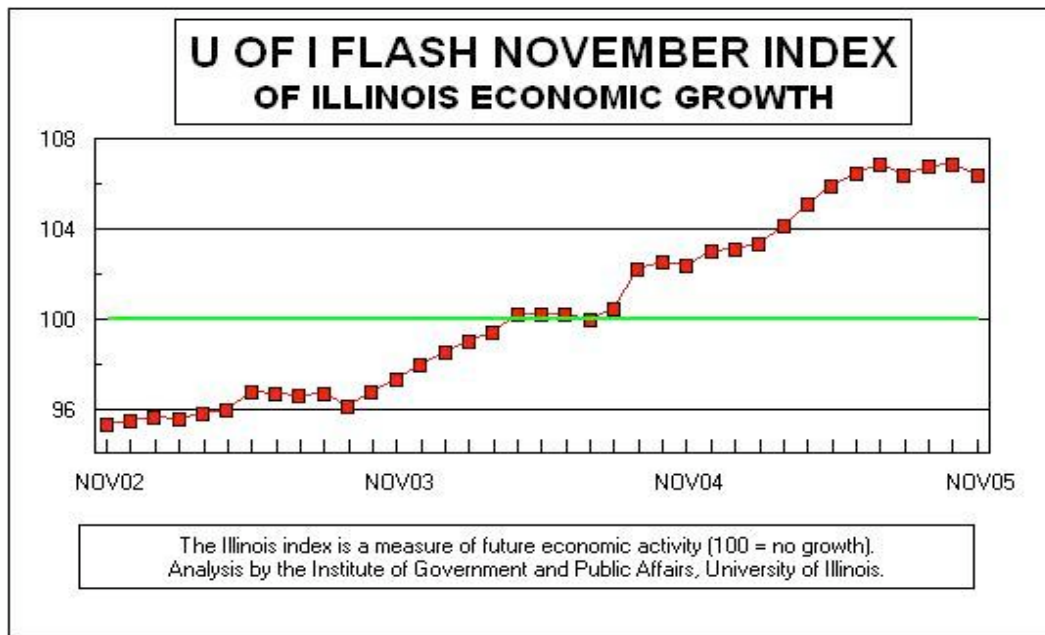
Sales-tax receipts were up slightly from November of last year, while income-tax receipts were down marginally. According to Giertz, corporate receipts were weak for the month, but this may be the result of the timing of payments, since November is historically a month of low corporate revenues. The Flash Index is a weighted average of state growth rates in consumer spending, corporate earnings and personal income. Tax receipts from corporate income, retail sales and personal income 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 November 30th.

October unemployment figures for Illinois were the lowest in four years. And this trend was repeated in many cities that have seen higher unemployment figures since 2001.

Illinois farm yields from the drought this past summer did not hit farmers as hard as was expected. Yields for corn and soybeans statewide were below the record levels of the previous year, but as sharply lower than expected.

According to a study at NIU, Illinois has suffered a net loss in higher-paying employment that has led to a decline in median household income of \$6,000 over the past 5 years.

Illinois has lost over 220,000 high-paying manufacturing jobs in the past 15 years. This loss of income has not been compensated by the addition of 533,000 service sector jobs in the state during the same time period. Several manufacturing plants in Illinois continue to lose jobs or will close: for example, ALCAN, an aluminum producer, announced it would close its Centralia plant by March 2006 and layoff 221 employees.



More than two-thirds of Illinois small business owners in a recent statewide survey say that they have been hurt by rising energy costs. Most have absorbed the energy cost increases rather than raising their prices to consumers. In addition, the survey found that only 12 percent of the Illinois business owners considered the state’s business environment as supportive, compared with 20 percent in Indiana, 37 percent in Iowa, and 31 percent in Missouri.

In November, the Illinois Commission on Governmental Forecasting and Accountability (the Legislative agency for economic forecasting and monitoring state debt) revised its current forecasts for FY 2006 state tax revenues, increasing them by about \$100 million due to stronger than expected economic performance. Funds from income and sales taxes are above projected levels. The State is now anticipating total revenue of growth of about \$700 million in FY 2006. But this good news is also offset by ongoing concerns over health care and Medicaid spending growth, some uncertainty about the cost and participation levels for the new All Kids Insurance program that will go into effect on July 1, 2006, unfunded pension system liabilities, cash flow availability in general funds to meet current year bills, an unbudgeted expenses such as the \$14 million for 4 percent raises recently approved by the Governor for merit-comp management level employees in state government.

While the national and state economies continue to expand at fairly robust rates, 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. This latest short term borrowing must be repaid by the end of FY 2006.

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.