INDIANA INCOME and NATIONAL PROJECTIONS

3rd Quarter 2005 through 2nd Quarter 2007

Prepared by
ECONOMIC FORECAST COMMITTEE

DECEMBER 14, 2005

GDP, U.S. PERSONAL INCOME, and INDIANA NON-FARM PERSONAL INCOME PROJECTIONS

3rd Quarter 2005 through 2nd Quarter 2007

Prepared by

ECONOMIC FORECAST COMMITTEE

December 14, 2005

COMMITTEE MEMBERS

Pat Barkey, Ball State University

Gary Baxter, Baxter Capital Management

David Teolis, General Motors Corporation

Bill Witte, Indiana University

SPECIAL ADVISOR

William Strauss, Federal Reserve Bank of Chicago

PREVIOUS FORECAST EVALUATION

In our April forecast we predicted that U.S. economic growth would slow slightly and that inflation would increase slightly during this year's first three quarters. In fact, output growth has held steady, and inflation has gone up somewhat more than we anticipated, resulting in Nominal GDP growth that was a modest 0.7% points higher than our forecast.

In spite of this faster growth, however, U.S. Personal Income growth was significantly below our estimate. The income shortfall was especially large in the third quarter (2.9% versus our estimate of 6.0%), with Hurricane Katrina accounting for about half of the shortfall. The overestimation of income carried over to the state level, but there our error was significantly smaller (0.3%).

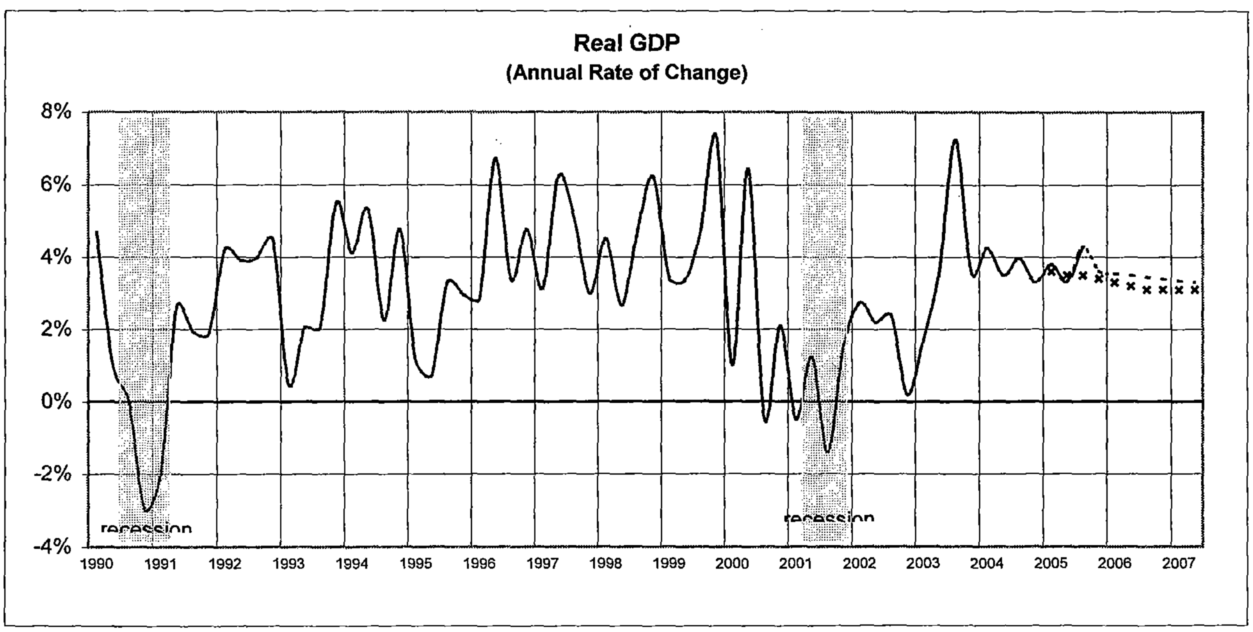
PREVIOUS FORECAST ERRORS (at annual rates)
Three quarters ending 3rd Quarter 2005

	Forecast	Actual	Error
Real Gross Domestic Product	3.5%	3.8%	-0.3%
GDP Deflator	2.5%	2.9%	-0.4%
Nominal Gross Domestic Product	6.1%	6.8%	-0.7%
U.S. Total Personal Income	4.7%	3.1%	+1.6%
IN Non-Farm Personal Income (2 quarters ending 2nd Qtr.)	4.1%	3.8%	+0.3%

REAL GROSS DOMESTIC PRODUCT

In April, we forecasted a gradual slowing in economic activity over the forecast period due to the effects of higher energy prices and a less accommodative monetary policy, as well as the maturation of the business expansion. We have raised our forecast modestly due to a somewhat stronger performance of the economy in spite of energy prices higher than our April expectation. However, we continue to believe that relatively high energy prices and continuing tightening by the Fed will cause a gradual slowing in growth over the next year and a half.

As shown in the chart below [x's are previous forecast] our forecast growth rate is below the rate in the third quarter, but roughly in line with the six previous quarters. Our forecast represents a balance of opposing elements. On the positive side, we expect that the recent moderation of high energy prices will continue. In addition, the national economy will be deriving some stimulus from the hurricane rebuilding effort. We also expect that the Federal deficit, business investment, and exports will provide some boost to economic activity. On the negative side, we think the Federal Reserve will continue to push short-term rates higher – to at least 4.5% and possibly farther – and we think long-term rates will rise as well. The rise in rates



will put pressure on the housing boom, causing growth in that sector to stall, and significantly slowing the rise in housing values, which has been occurring in much of the country. With housing price increases moderating, the ability of households to use refinancing activity to augment their incomes will cause some slowing in consumer spending.

The Federal Reserve has raised its target overnight Federal funds rate 13 times since June 2004 – from 1.0% to 4.25% so far. Over that period mortgage rates have increased by a more modest 1 1/4% points. Still, this has been enough of a rise to significantly slow the refinancing of mortgages. Mortgage refinancing has also been stimulated by double digit annual increases in home prices in many local markets, although not in Indiana. This year, in approximately 70% of these refinancings, cash has been taken out. A lot of cash - $165 billion in the first nine months of this year. That is only slightly less than the increase in total wages and salaries for that same period. A Federal Reserve study estimates that if home equity loans and capital gains from home sales are added to cash out refinancing, Americans pulled $599 billion in equity from their homes last year. The authors estimate that about half of this money gets spent over time. Our committee feels that past home cash outs provide a significant reservoir to support future spending even as new cash outs are reduced.

An increase in the personal savings over the forecast period could reduce the rate of consumer spending some. Savings, which is current income less spending, has been negative since April of this year. That is, spending has been greater than income. This in good part due to the refinancing cash outs discussed above. The cash outs are not included in the Federal government's personal income measure, but the associated spending is counted, producing the lowest savings rate on record. As home equity withdrawals drop off, consumers may be forced to save more out of current income.

The recovery from Hurricane Katrina will add to economic activity over an extended period of time. The U.S. Department of Commerce estimates that $317 billion of damage was done to fixed assets. If completely replaced, that would add 2.5% to GDP. Of course, the replacement will be spread over several years. By one estimate, approximately 600,000 cars were destroyed. The National Association of Homebuilders estimates that 500,000 homes sustained serious damage but can be repaired and 350,000 homes have been destroyed, which is more than 12 times the number wiped out by any previous natural disaster in the nation's history. With residential construction at record levels, markets for building materials and labor were already tight prior to the storms. Cleanup and repair will be the initial effort, followed by demolition and rebuilding only after infrastructure is rebuilt. Of course, some of the rebuilding will occur outside the damaged areas. Going forward, there will be no way to directly measure the impact of the rebuilding on GDP.

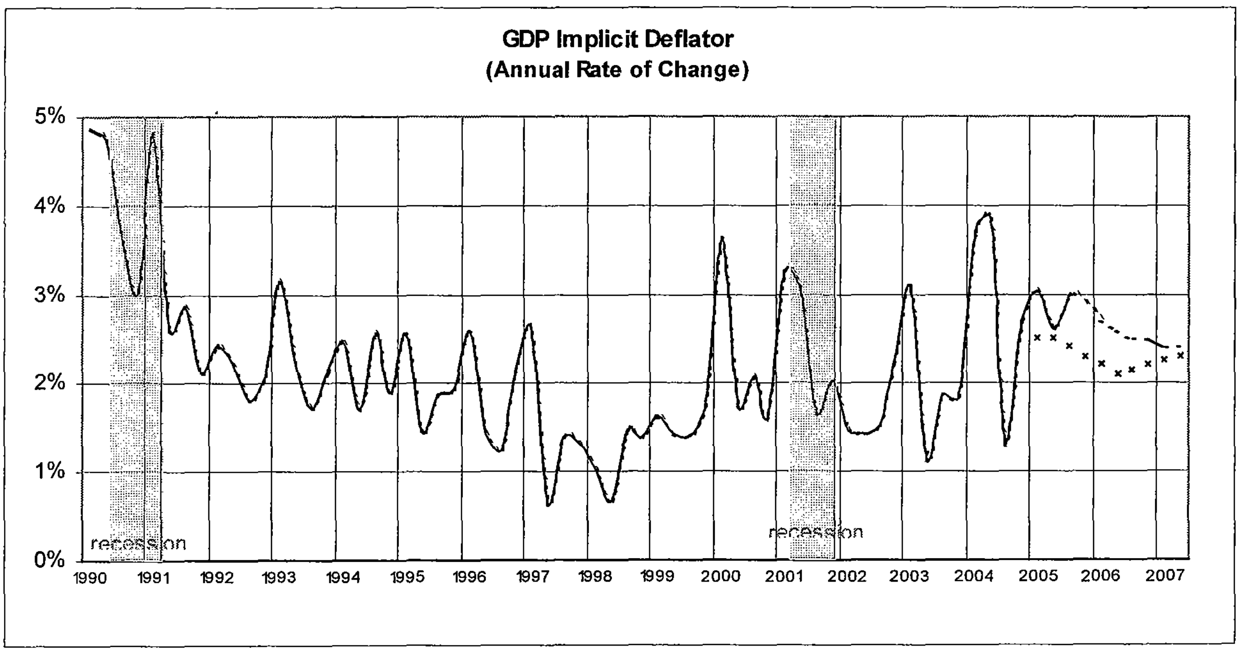
The table below shows the forecast for the next two fiscal years, which is about one-third point higher than our previous forecast.

Real GDP
Current and Previous Forecast
(2nd Quarter to 2nd Quarter)

	Current 12/14/05	Previous 4/11/05	% Point Difference
FY 2005-06	3.7%	3.3%	0.4%
FY 2006-07	3.4%	3.1%	0.3%

GDP IMPLICIT DEFLATOR

As can be seen in the chart below, over the past six years the overall inflation rate has shown great variation from quarter to quarter largely due to fluctuations in energy prices. While this volatility in energy prices is likely to continue, we expect the broad trend over the next year will be moderately downward. This, together with some slowing in the real economy, causes the overall inflation rate to gradually fall from the current 3.0% to 2.4% by mid-2007. The balance between supply and demand in the energy markets is very tight, however, implying that upward spikes in prices remain a possibility. Such an occurrence, if severe, would put our entire forecast at risk.



Even excluding food and energy, core prices have been rising from a low of 1.1% (12 month change) in late 2003. By the end of 2004, the core Personal Consumption Expenditure Deflator reached a 12-month growth rate of 2.3%. The main reason for the Federal Reserve's recent tightening is to keep inflation in check. It appears to be working – this core measure most recently was back down to 1.8%.

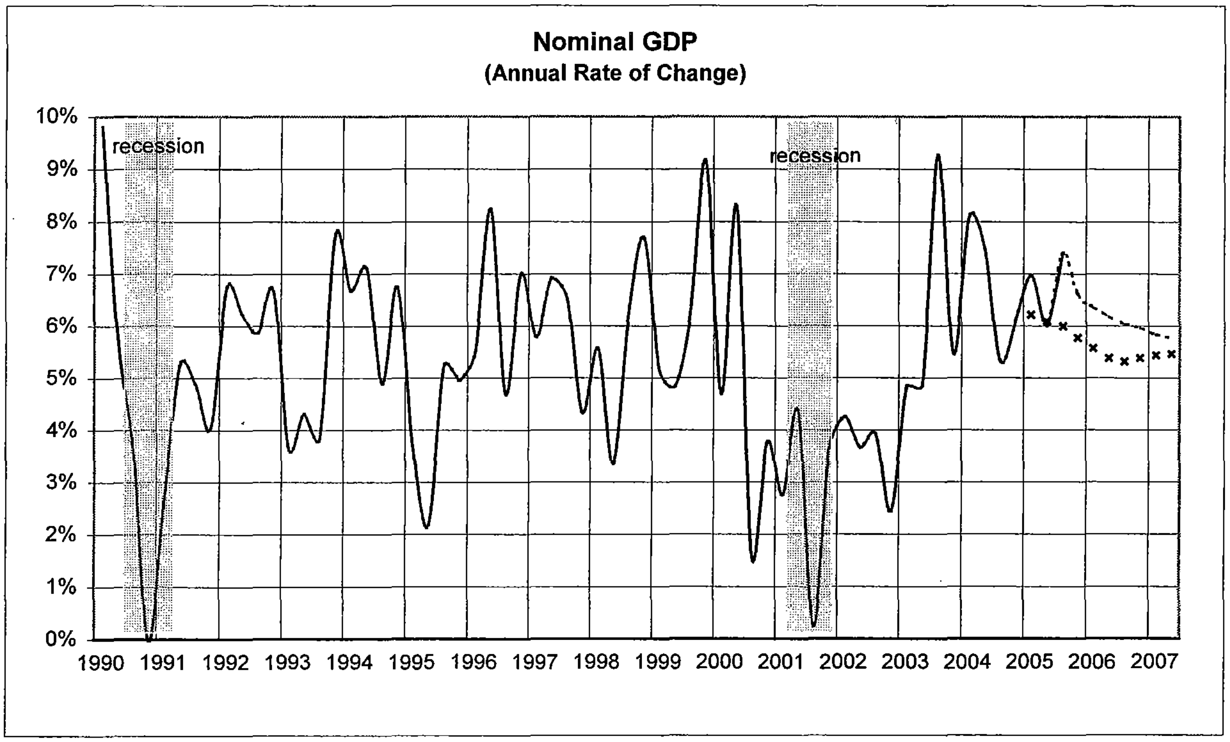
The table below shows that our forecast is higher this fiscal year by ½% more than the previous one. The increase is primarily due to higher energy prices. Our forecast is only 0.2% higher in the next fiscal year.

GDP Implicit Price Deflator
Current and Previous Forecast
(2nd Quarter to 2nd Quarter)

	Current 12/14/05	Previous 4/11/05	% Point Difference
FY 2005-06	2.8%	2.3%	0.5%
FY 2006-07	2.4%	2.2%	0.2%

NOMINAL GROSS DOMESTIC PRODUCT

Combining our higher forecast for both the real economy and inflation, results in a more sizable increase in the nominal GDP numbers.

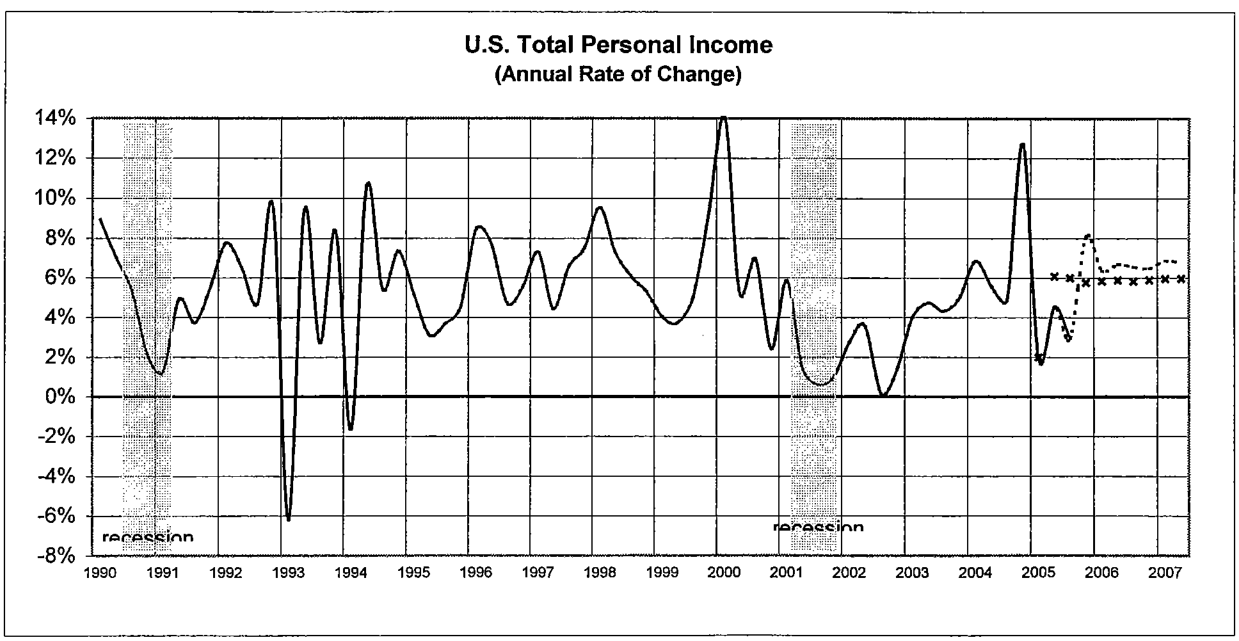


Nominal GDP
Current and Previous Forecast
(2^{nd} Quarter to 2^{nd} Quarter)

	Current 12/14/05	Previous 4/11/04	% Point Difference
FY 2005-06	6.6%	5.7%	0.9%
FY 2006-07	5.9%	5.4%	0.5%

U.S. TOTAL PERSONAL INCOME

Quarterly personal income growth has been distorted by two factors during the past year. The first, affecting the fourth quarter of 2004 (positively) and the first quarter of this year (negatively) was the special Microsoft dividend in December 2004. The second was the hurricanes, which negatively affected the third quarter income number and will push up measured growth in the fourth quarter. Discounting these distortions, we expect that personal income growth will show a slight acceleration over the next year and a half. Since we expect nominal GDP growth to decelerate, this implies a significant rise in the ratio of personal income to GDP. Two elements will contribute to this outcome. First, we expect that the share of national income going to corporate profits, which has risen dramatically over the past couple years will be reduced. Second, and directly related to the profit slowdown, we expect the share of income that goes to labor will rise as the labor market progressively tightens. By mid-2006 our forecast implies a labor market that is close to full employment.



Interest income and dividends are expected to be significant contributors to income growth. Higher interest income is primarily due to rising interest rates. Dividends, which are regularly setting new record highs, are being driven by strong profits and the new lower tax rate on dividends.

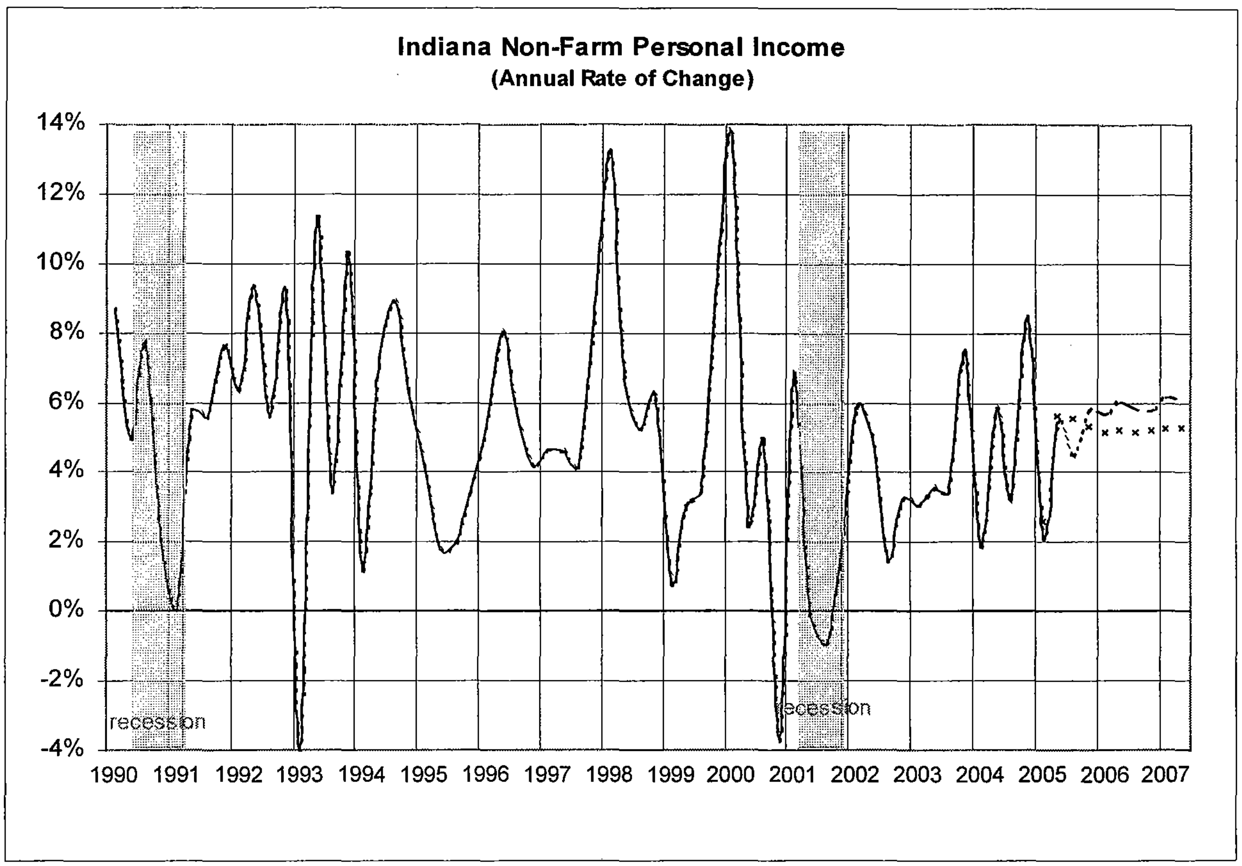
The table below shows that our new forecast is not much different than our previous one for this fiscal year, but is significantly higher for the next fiscal year.

U.S. Total Personal Income
Current and Previous Forecast
(2nd Quarter to 2nd Quarter)

	Current 12/14/05	Previous 4/11/04	% Point Difference
FY 2005-06	6.0%	5.9%	0.1%
FY 2006-07	6.7 %	5.9%	0.8%

INDIANA NON-FARM PERSONAL INCOME

For over half a century Indiana personal income has lost ground relative to the nation. We expect this trend to continue over the forecast period. There are a number of underlying causes. To begin with, population growth in Indiana is below that for the U.S. as a whole, and to some extent this carries over to employment. But even more important, the sectors of the Indiana economy with the highest average incomes (in particular, manufacturing) are those in which employment growth is lowest, while areas in which employment in the state is rising are predominantly sectors with below average income levels. Since its low point in early 2002, for example, Indiana payroll employment has grown by 74 thousand, roughly matching the growth rate of national employment. However, over the same period, the state's manufacturing sector has lost 16 thousand jobs. In relative terms this is significantly better than manufacturing at the national level, but it still implies downward pressure on the growth of state income.



Looking to the future, we expect to see growth in Indiana income that continues below that for the nation. However, as can be seen in the above chart, this situation will result in income growth over the period ahead that is substantially better than the past several years. From the beginning of 2001 through the second quarter of this year Indiana non-farm personal income growth averaged only 3.7%. For the two years beginning with this year's third quarter our forecast is for average income growth of 5.8%. This forecast is higher than last April's by 0.2% this fiscal year and 0.8% next fiscal year.

Indiana Non-Farm Personal Income
Current and Previous Forecast
(Quarterly Data Annualized)
Fiscal Years are 2nd Quarter to 2nd Quarter)

	Current 12/14/05	Previous 4/11/04	% Point Difference
2005:3	4.5%	5.6%	-1.1%
2005:4	5.8%	5.3%	0.5%
2006:1	5.7%	5.2%	0.5%
2006:2	6.0%	5.2%	0.8%
2006:3	5.9%	5.2%	0.7%
2006:4	5.8%	5.2%	0.6%
2007:1	6.2%	5.3%	0.9%
2007:2	6.1%	5.3%	0.8%
FY 2005-06	5.5%	5.3%	0.2%
FY 2006-07	6.0%	5.2%	0.8%

GROSS DOMESTIC PRODUCT PROJECTIONS
December 14, 2005

		Gross Domestic Product Billions of $		GDP Implicit Price Deflator	Quarterly Percent Changes At Annual Rates		
		Real	**Nominal**	**1996=100**	**Real**	**Deflator**	**Nominal**
Actual:							
2001	Q1	9,875.6	10,021.5	101.4774	-0.5	3.3	2.8
	Q2	9,905.9	10,128.9	102.2512	1.2	3.1	4.4
	Q3	9,871.1	10,135.1	102.6745	-1.4	1.7	0.2
	Q4	9,910.0	10,226.3	103.1917	1.6	2.0	3.6
2002	Q1	9,977.3	10,333.3	103.5681	2.7	1.5	4.3
	Q2	10,031.6	10,426.6	103.9376	2.2	1.4	3.7
	Q3	10,090.7	10,527.4	104.3277	2.4	1.5	3.9
	Q4	10,095.8	10,591.1	104.9060	0.2	2.2	2.4
2003	Q1	10,138.6	10,717.0	105.7049	1.7	3.1	4.8
	Q2	10,230.4	10,844.6	106.0037	3.7	1.1	4.8
	Q3	10,410.9	11,087.4	106.4980	7.2	1.9	9.3
	Q4	10,502.6	11,236.0	106.9830	3.6	1.8	5.5
2004	Q1	10,612.5	11,457.1	107.9585	4.3	3.7	8.1
	Q2	10,704.1	11,666.1	108.9872	3.5	3.9	7.5
	Q3	10,808.9	11,818.8	109.3432	4.0	1.3	5.3
	Q4	10,897.1	11,995.2	110.0770	3.3	2.7	6.1
2005	*Q1*	10,999.3	12,198.8	110.9052	3.8	3.0	7.0
	Q2	11,089.2	12,378.0	111.6221	3.3	2.6	6.0
	Q3	11,206.1	12,601.0	112.4477	4.3	3.0	7.4
Projections:							
	Q4	*11,305.6*	*12,803.6*	*113.25*	*3.6*	*2.9*	*6.6*
2006	*Q1*	*11,404.6*	*13,002.4*	*114.01*	*3.5*	*2.7*	*6.4*
	Q2	*11,503.1*	*13,198.7*	*114.74*	*3.5*	*2.6*	*6.2*
	Q3	*11,601.1*	*13,393.5*	*115.45*	*3.5*	*2.5*	*6.0*
	Q4	*11,698.5*	*13,589.0*	*116.16*	*3.4*	*2.5*	*6.0*
2007	*Q1*	*11,795.3*	*13,782.8*	*116.85*	*3.4*	*2.4*	*5.8*
	Q2	*11,891.4*	*13,977.2*	*117.54*	*3.3*	*2.4*	*5.8*

Indiana Fiscal Years (Ending June 30th)	Percent Changes (Q2-Q2)		
2001-02	1.3	1.6	2.9
2002-03	2.0	2.0	4.0
2003-04	4.6	2.8	7.6
2004-05	3.6	2.4	6.1
2005-06	*3.7*	*2.8*	*6.6*
2006-07	*3.4*	*2.4*	*5.9*

PERSONAL INCOME PROJECTIONS

December 14, 2005

		U.S. Total Billions of $	Indiana Nonfarm Millions of $	Quarterly Percent Changes At Annual Rates U.S.	Indiana
Actual:					
2001	Q1	8,688.7	167,520	5.9	6.8
	Q2	8,719.9	167,478	1.4	-0.1
	Q3	8,733.1	167,073	0.6	-1.0
	Q4	8,754.8	167,627	1.0	1.3
2002	Q1	8,814.7	170,034	2.8	5.9
	Q2	8,892.0	172,135	3.6	5.0
	Q3	8,895.4	172,787	0.2	1.5
	Q4	8,925.5	174,154	1.4	3.2
2003	Q1	9,013.7	175,462	4.0	3.0
	Q2	9,118.6	177,012	4.7	3.6
	Q3	9,215.4	178,523	4.3	3.5
	Q4	9,328.7	181,796	5.0	7.5
2004	Q1	9,484.8	182,617	6.9	1.8
	Q2	9,614.3	185,230	5.6	5.8
	Q3	9,729.2	186,706	4.9	3.2
	Q4	10,024.8	190,547	12.7	8.5
2005	*Q1*	10,073.4	191,551	2.0	2.1
	Q2	10,185.7	194,126	4.5	5.5
	Q3	10,259.7	*196,268*	2.9	*4.5*
Projections:					
	Q4	*10,460.5*	*199,063*	*8.1*	*5.8*
2006	*Q1*	*10,623.0*	*201,837*	*6.4*	*5.7*
	Q2	*10,796.5*	*204,810*	*6.7*	*6.0*
	Q3	*10,969.3*	*207,759*	*6.6*	*5.9*
	Q4	*11,143.0*	*210,714*	*6.5*	*5.8*
2007	*Q1*	*11,329.5*	*213,901*	*6.9*	*6.2*
	Q2	*11,517.2*	*217,099*	*6.8*	*6.1*

Indiana Fiscal Years (Ending June 30th)	Percent Changes (Q2-Q2)	
2001-02	2.0	2.8
2002-03	2.5	2.8
2003-04	5.4	4.6
2004-05	5.9	4.8
2005-06	*6.0*	*5.5*
2006-07	*6.7*	*6.0*