

INDIANA INCOME and NATIONAL
PROJECTIONS
1st Quarter 2007 through 2nd Quarter 2009

Prepared by
ECONOMIC FORECAST COMMITTEE

April 16, 2007

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

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PREVIOUS FORECAST EVALUATION

Economic data in the four months since our December 2006 forecast have conformed closely to the path projected in that report. For the national economy, we forecasted fourth quarter growth in real GDP of 2.0%, compared to the actual 2.5%. Increase in the GDP deflator, on the other hand, was 0.3% below our forecast 1.9%. In both cases an underlying factor in our error was a slightly more positive effect of the moderation in energy prices that occurred toward the end of the year. Our offsetting errors yielded Nominal GDP growth that was a modest 0.2% points higher than our forecast. Even this small error did not carry over to U.S. Personal Income growth, which at 4.7 percent exactly matched our estimate. In light of our underestimate of nominal GDP, this means that the ratio of personal income to GDP was a little below our estimate. This can be traced to somewhat disappointing growth in labor income.

Since our December forecast data on Indiana non-farm personal income have been released for both the 3rd and 4th quarters of last year. For that two-quarter period, our December forecast was slightly pessimistic. As can be seen in the table below, Indiana income grew at an annual rate of 4.0%. That was 0.2% above our estimate, but still well below the national rate, which was 4.8% for that period.

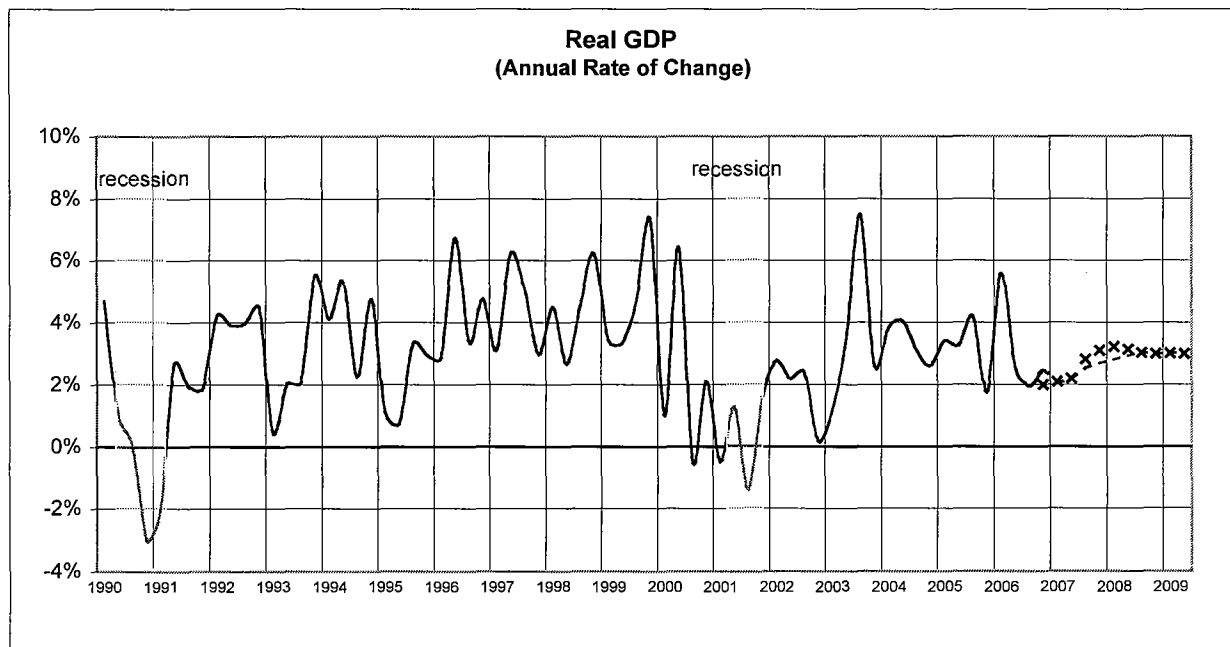
PREVIOUS FORECAST ERRORS (at annual rates)

4th Quarter 2006

	<u>Forecast</u>	<u>Actual</u>	<u>Error</u>
U.S. Real Gross Domestic Product	2.0%	2.5%	-0.5%
U.S. GDP Deflator	1.9%	1.6%	+0.3%
U.S. Nominal GDP	3.9%	4.1%	-0.2%
U.S. Total Personal Income	4.7%	4.7%	0.0%
IN Non-Farm Personal Income (2 quarters ending 4 th Qtr.)	3.8%	4.0%	-0.2%

REAL GROSS DOMESTIC PRODUCT

As shown in the chart below our forecast for output growth is for a sluggish performance through mid-2007, and then acceleration to a level of about 3 percent. For the four quarters of fiscal year 2008, this is a slightly weaker outlook than in our December forecast [x's are previous forecast]. Otherwise the current forecast is little different from our December outlook.



As in December our forecast represents an uneasy balance of opposing elements. On the positive side, the national labor market remains very healthy – indeed, better than we expected. This will provide support for household real income (that is, income adjusted for inflation). The international trade picture has improved. The very large fourth quarter drop in the trade deficit was probably partly an anomaly, but the underlying trend is clearly positive, and we expect exports to provide a definite boost to economic activity.

On the negative side, our view of the housing sector has become more pessimistic. We continue to expect that the housing slowdown will persist through most of 2007, with the sub-prime mortgage problems adding some downward pressure. We are also a little more pessimistic about the prospects for business investment, which actually declined in the fourth quarter.

The key to the outlook over the next year is household consumption. To date consumer spending has held up quite well. In the fourth quarter, it rose at an annual rate of 4.2%. But as we discussed in December, there are heavy pressures on household budgets. Three important elements of this pressure are the housing situation, energy prices, and the low level of household saving. There has been no improvement in any of these areas over the past four months. In fact, the first two have probably become slightly more ominous. Offsetting their downward pull is the current situation in the labor market mentioned earlier. At the national level, this has been a clear positive, both in terms of employment and in terms of income growth. The economy has been generating jobs at a rate in excess of 150 thousand per month. This has been sufficient to pull the unemployment rate steadily lower – to only 4.4% currently. As the labor market has tightened, especially recently, wages have started to rise, even with adjustment for inflation. Rising income and good job prospects are solid barriers against a collapse in household spending.

Two underlying factors that affect our forecast warrant discussion: the outlook for monetary policy and for oil prices. Regarding the former, the Federal Reserve continues to hold its target for the federal funds rate at 5.25%. However, the core inflation rate (excluding food and energy) remains well above the Fed's presumed comfort level. We think this will keep the Fed policy on hold through the rest of this year. Beyond that, we think Fed policy will be driven by incoming data, with about equal probability of higher or lower rates.

Crude oil prices will continue to be very volatile for a considerable period. As in December, we still expect the price to average between \$60 and \$65 over the next two years, although with some periods above and below that range.

In summary, we expect that the national economy will struggle through the remainder of this year, with rising exports and adequate consumer spending offsetting continuing contraction in housing. In 2008 and beyond the economy will regain some momentum as the drag from the housing sector diminishes. The table below compares our current forecast with that done in December.

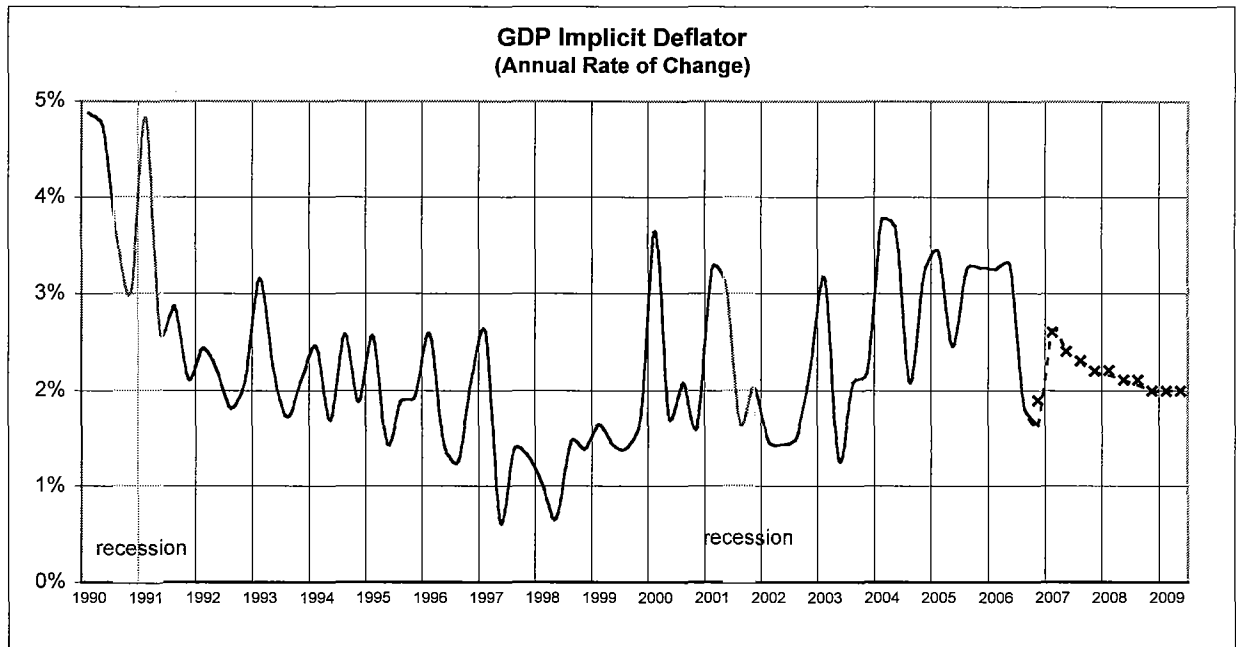
Although our forecast, particularly near-term, is not especially upbeat, the risks seem mostly to the downside. The housing sector continues to be a source of danger. If housing construction and particularly housing prices decline more than we expect, or if the sub-prime problems spread to credit availability in general, the damage to household budgets could

significantly impact on household spending in general. A return to much higher energy prices could carry the same risk. In either case, there would be a risk of recession. At present we would put that risk at about 15-20 percent.

Real GDP Current and Previous Forecast (2 nd Quarter to 2 nd Quarter)			
	<u>Current</u> <u>4/16/07</u>	<u>Previous</u> <u>12/14/06</u>	<u>% Point</u> <u>Difference</u>
FY 2006-07	2.2%	2.1%	+0.1%
FY 2007-08	2.7%	3.0%	-0.3%
FY 2008-09	3.0%	3.0%	0.0%

GDP IMPLICIT DEFLATOR

As can be seen in the chart below, after an extended period in which inflation averaged at or below 2%, the overall inflation rate has moved up close to 3% during most of the past two years. There is, however, considerable quarter-to-quarter volatility due in large part to fluctuations in energy prices. While this volatility in energy prices is likely to continue, we expect the broad trend over the next two and a half years will be downward. We think the decrease in the fourth quarter was largely due to lower energy prices. With energy prices having come back up, we expect a rebound to above 2.5%, followed by a gradual decline to about 2% by late 2008. This pattern is essentially unchanged from December.



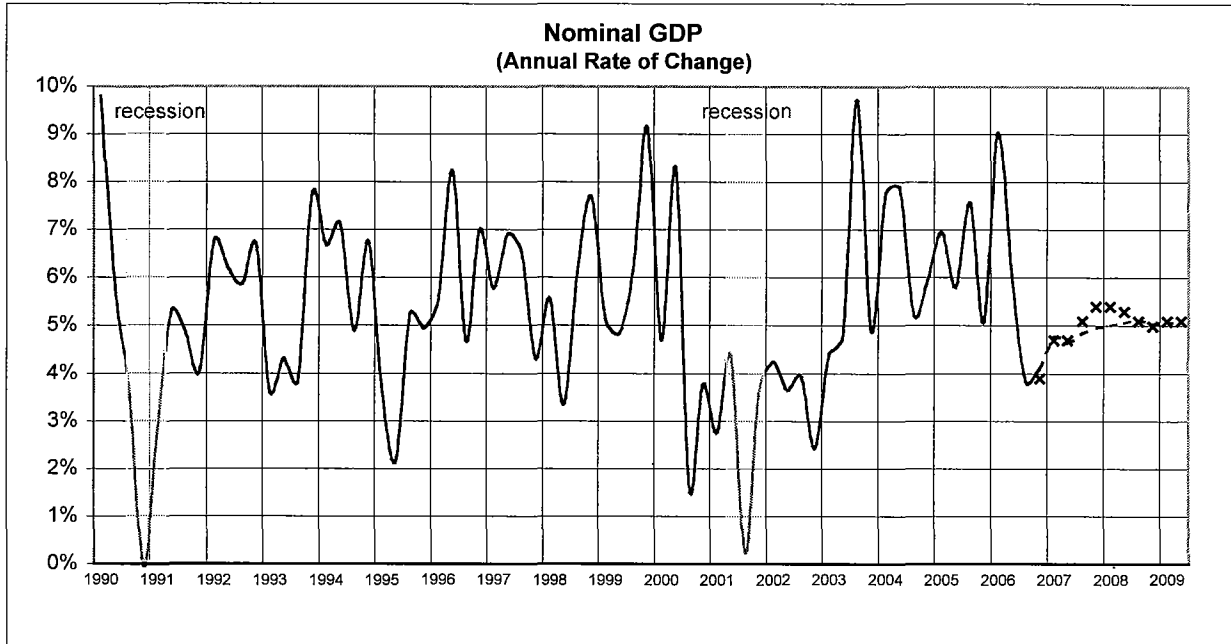
As with output, there are a number of crosscurrents in the inflation outlook. A positive factor is the slowdown in economic growth we see for the rest of this year, which could alleviate some pressure on industrial capacity. On the other side of the ledger, the tight labor market is causing labor costs to rise, and depreciation of the dollar (which we expect to continue) will put upward pressure on import prices. Rising import prices could enhance the ability of domestic firms to pass on increases in their costs. In addition, the strength we see in the world economy will continue to put pressure on commodity prices.

The table below shows our forecast for the GDP deflator for the current and next two fiscal years.

	Current <u>4/16/07</u>	Previous <u>12/14/06</u>	<u>% Point Difference</u>
FY 2006-07	2.1%	2.2%	-0.1%
FY 2007-08	2.2%	2.2%	0.0%
FY 2008-09	2.0%	2.0%	0.0%

NOMINAL GROSS DOMESTIC PRODUCT

Combining our sluggish forecast for the real economy with our moderating path for inflation, results in moderate growth for nominal GDP.



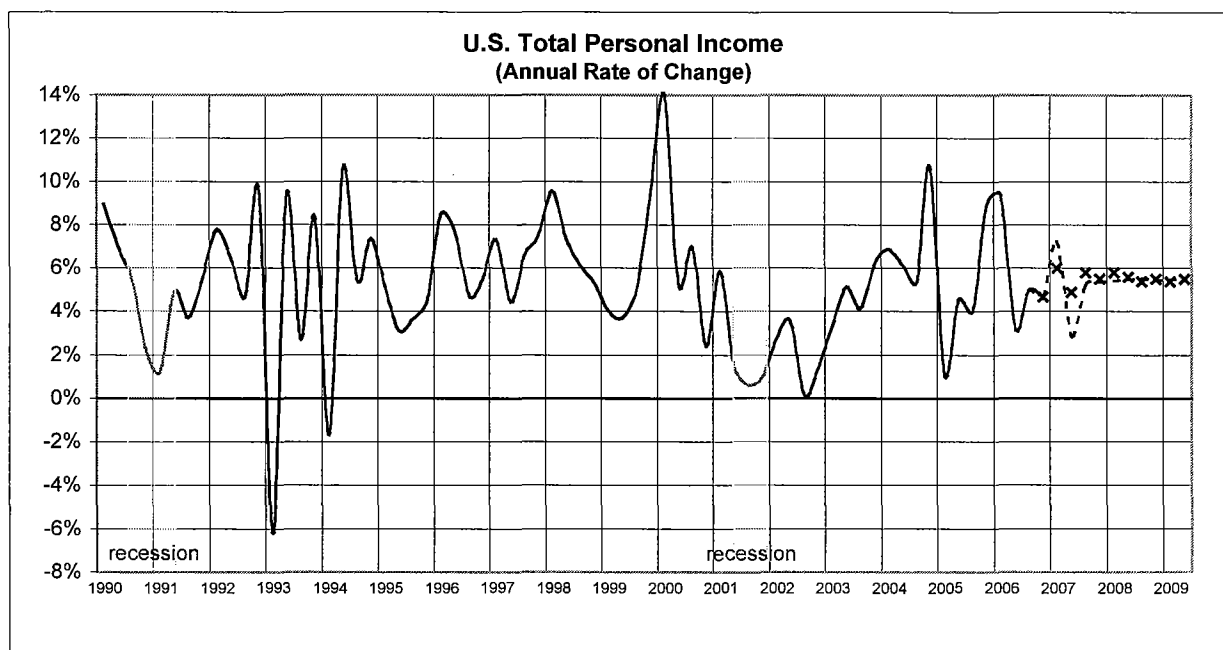
Nominal GDP Current and Previous Forecast (2 nd Quarter to 2 nd Quarter)			
	<u>Current</u> 4/16/07	<u>Previous</u> 12/14/06	<u>% Point</u> <u>Difference</u>
FY 2006-07	4.3%	4.3%	0.0%
FY 2007-08	5.0%	5.3%	-0.3%
FY 2008-09	5.1%	5.1%	0.0%

U.S. TOTAL PERSONAL INCOME

After lagging for the first three years of the current expansion, personal income growth has been averaging close to growth in nominal GDP during the past two years. We expect further improvement in the period ahead.

The relatively slow income growth over the past five years has been associated with a dramatic shift in the shares of total national income toward capital at the expense of labor. We think that 2006 marked the end of this trend for the current cycle. With a tighter labor market, rising real wages are increasing labor income and will put pressure on business profits. The ratio of personal income to nominal GDP will consequently rise. This is similar to the pattern during the second half of the long expansion during the 1990s. Our forecast for the first quarter of 2007 includes above trend growth in income to account for the unusually large bonuses that have been paid in the financial sector. Other than that, we think personal income should move generally in tandem with nominal GDP, except on a slightly faster growth path.

The result is income growth in the mid five percent range as can be seen in the chart and table below.

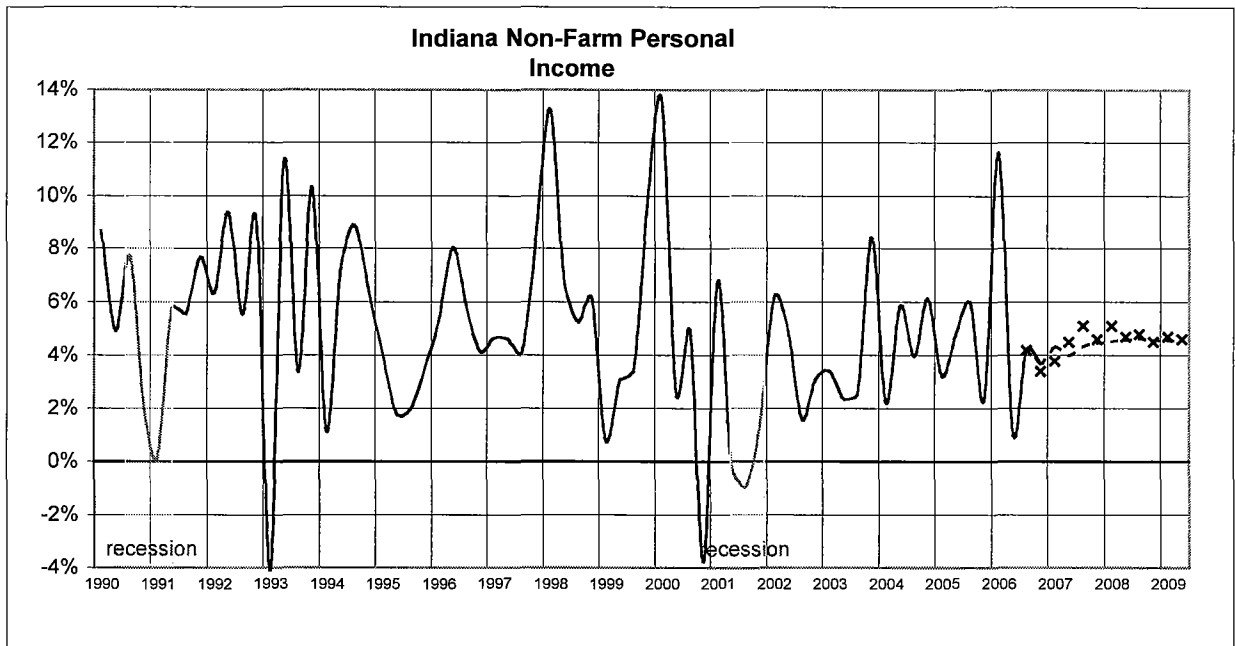


U.S. Total Personal Income
Current and Previous Forecast
(2nd Quarter to 2nd Quarter)

	<u>Current</u> <u>4/16/07</u>	<u>Previous</u> <u>12/14/06</u>	<u>% Point</u> <u>Difference</u>
FY 2006-07	4.9%	5.3%	-0.4%
FY 2007-08	5.4%	5.7%	-0.3%
FY 2008-09	5.5%	5.4%	+0.1%

INDIANA NON-FARM PERSONAL INCOME

For over half a century Indiana personal income has lost ground relative to the nation, a trend that continues in recent data. On average, since a brief surge early in the current expansion, Indiana non-farm personal income followed a growth pattern similar to U.S. personal income, but with a growth rate about one percent lower. As in December, 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.



Looking to the future, we expect to see growth in Indiana income that continues below that for the nation. As can be seen in the above chart, this situation results in income growth over the period ahead that is generally in line with the past several years. From mid 2002 through the fourth quarter of 2006 Indiana non-farm personal income growth averaged 4.2% (compared with 5.0% for the U.S.). For the two and one-half years beginning with this year's first quarter our forecast is for average income growth of 4.5% (versus 5.4% at the national

level). Quarterly growth starts below this average due to a sluggish economy, and then rises somewhat after mid-2007.

Indiana Non-Farm Personal Income Current and Previous Forecast (Quarterly Data Annualized) Fiscal Years are 2 nd Quarter to 2 nd Quarter			
	<u>Current</u> <u>4/16/07</u>	<u>Previous</u> <u>12/14/06</u>	<u>% Point</u> <u>Difference</u>
2007:1	4.3%	3.8%	+0.5%
2007:2	4.0%	4.5%	-0.5%
2007:3	4.4%	5.1%	-0.7%
2007:4	4.5%	4.6%	-0.1%
2008:1	4.5%	5.1%	-0.6%
2008:2	4.6%	4.7%	-0.1%
2008:3	4.6%	4.8%	-0.2%
2008:4	4.5%	4.5%	0.0%
2009:1	4.6%	4.7%	-0.1%
2009:2	4.6%	4.6%	0.0%
FY 2006-07	4.1%	4.0%	+0.1%
FY 2007-08	4.5%	4.9%	-0.4%
FY 2008-09	4.6%	4.7%	-0.1%

GROSS DOMESTIC PRODUCT PROJECTIONS

April 16, 2007

		Gross Domestic Product		GDP Implicit Price Deflator 2000=100	Quarterly Percent Changes		
		Billions of \$			At Annual Rates		
		Real	Nominal		Real	Deflator	Nominal
<i>Actual:</i>							
2003	Q1	10126.0	10,705.6	105.724	1.2	3.2	4.4
	Q2	10212.7	10,831.8	106.062	3.5	1.3	4.8
	Q3	10398.7	11,086.1	106.610	7.5	2.1	9.7
	Q4	10467.0	11,219.5	107.189	2.7	2.2	4.9
2004	Q1	10566.3	11,430.9	108.183	3.8	3.8	7.8
	Q2	10671.5	11,649.3	109.163	4.0	3.7	7.9
	Q3	10753.3	11,799.4	109.728	3.1	2.1	5.3
	Q4	10822.9	11,970.3	110.602	2.6	3.2	5.9
2005	Q1	10913.8	12,173.2	111.540	3.4	3.4	7.0
	Q2	11001.8	12,346.1	112.219	3.3	2.5	5.8
	Q3	11115.1	12,573.5	113.121	4.2	3.3	7.6
	Q4	11163.8	12,730.5	114.034	1.8	3.3	5.1
2006	Q1	11316.4	13,008.4	114.952	5.6	3.3	9.0
	Q2	11388.1	13,197.3	115.887	2.6	3.3	5.9
	Q3	11443.5	13,322.6	116.421	2.0	1.9	3.9
	Q4	11513.0	13,458.2	116.896	2.5	1.6	4.1
<i>Projections:</i>							
2007	Q1	11,573.0	13,615.6	117.650	2.1	2.6	4.8
	Q2	11,636.1	13,771.3	118.350	2.2	2.4	4.7
	Q3	11,708.2	13,935.1	119.020	2.5	2.3	4.8
	Q4	11,786.4	14,104.8	119.670	2.7	2.2	5.0
2008	Q1	11,868.1	14,278.5	120.310	2.8	2.2	5.0
	Q2	11,953.2	14,456.2	120.940	2.9	2.1	5.1
	Q3	12,041.9	14,638.1	121.560	3.0	2.1	5.1
	Q4	12,131.2	14,819.5	122.160	3.0	2.0	5.0
2009	Q1	12,221.2	15,004.0	122.770	3.0	2.0	5.1
	Q2	12,311.8	15,190.3	123.380	3.0	2.0	5.1
					Percent Changes		
					(Q2-Q2)		
Indiana Fiscal Years (Ending June 30th)							
2002-03					1.8	2.0	3.9
2003-04					4.5	2.9	7.5
2004-05					3.1	2.8	6.0
2005-06					3.5	3.3	6.9
2006-07					2.2	2.1	4.3
2007-08					2.7	2.2	5.0
2008-09					3.0	2.0	5.1

PERSONAL INCOME PROJECTIONS

April 16, 2007

		U.S. Total Billions of \$	Indiana Nonfarm Millions of \$	Quarterly Percent Changes At Annual Rates	
				U.S.	Indiana
<i>Actual:</i>					
2003	Q1	8,998.2	175,696	3.3	3.4
	Q2	9,111.3	176,728	5.1	2.4
	Q3	9,203.6	177,867	4.1	2.6
	Q4	9,341.3	181,500	6.1	8.4
2004	Q1	9,497.7	182,502	6.9	2.2
	Q2	9,640.5	185,112	6.2	5.8
	Q3	9,767.9	186,931	5.4	4.0
	Q4	10,019.4	189,722	10.7	6.1
2005	Q1	10,048.8	191,240	1.2	3.2
	Q2	10,161.5	193,524	4.6	4.9
	Q3	10,262.7	196,326	4.0	5.9
	Q4	10,483.7	197,496	8.9	2.4
2006	Q1	10,721.4	202,999	9.4	11.6
	Q2	10,807.3	203,585	3.2	1.2
	Q3	10,939.4	205,693	5.0	4.2
	Q4	11,065.5	207,568	4.7	3.7
<i>Projections:</i>					
2007	Q1	11,260.1	209,776	7.2	4.3
	Q2	11,340.7	211,844	2.9	4.0
	Q3	11,486.7	214,112	5.2	4.4
	Q4	11,637.9	216,465	5.4	4.5
2008	Q1	11,792.6	218,871	5.4	4.5
	Q2	11,950.9	221,331	5.5	4.6
	Q3	12,113.0	223,848	5.5	4.6
	Q4	12,275.0	226,351	5.5	4.5
2009	Q1	12,439.8	228,892	5.5	4.6
	Q2	12,606.4	231,454	5.5	4.6

Indiana Fiscal Years (Ending June 30th)

Percent Changes (Q2-Q2)

2002-03	2.5	2.6
2003-04	5.8	4.7
2004-05	5.4	4.5
2005-06	6.4	5.2
2006-07	4.9	4.1
2007-08	5.4	4.5
2008-09	5.5	4.6