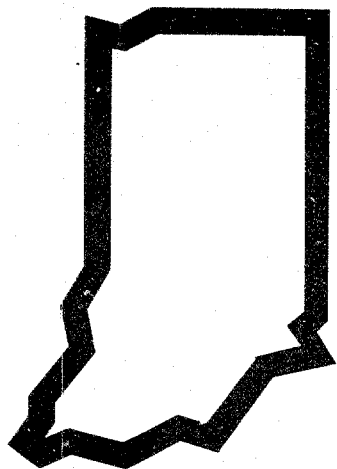


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Indiana Business Review

OUT LOOK '96

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The annual outlook edition of the *Indiana Business Review* has been published for more than a quarter of a century. We believe you will find this year's edition among the most geographically comprehensive (combining global and national trends with local analysis) and one of the more insightful. We hope to increase the number of regional articles for the 1997 outlook, bringing readers news from areas of the state not represented in this issue.

For those readers who may not have noticed, the *Indiana Business Review* is now published monthly. It comes to you in the form you now hold in your hands, in the form of the *Update* (a four-page review of current trends in the national and state economies), or both together, with the *Update* as an insert. Quite simply, content determines what form the IBR will take in a given month. Suggestions? Comments? Criticism? Please let us know by e-mail (rogersc@indiana.edu) or by mail: C.O. Rogers, IBRC, IU School of Business, 10th and Fee Lane, Bloomington IN 47405.

The 1996 Outlook: Introduction and Overview

Bruce Jaffee

Chairperson and Professor of Business Economics & Public Policy, Indiana University School of Business

The short and generally mild recession of 1990-91 has now been followed by four years of recovery and expansion. In 1995 we have seen solid growth led by business investment in equipment, coupled with low inflation, rising personal incomes, and near full employment. Though the growth rate in the overall economy is expected to slacken to about 2.5% in 1996, we generally see a continuation of most current trends into next year. In one sense, this "more of the same" forecast is not very exciting. On the other hand, a fifth year in a row that is recession-free, near capacity, with inflation under control, is an enviable record. Our forecast is summarized in the **Table** below.

The key "driver" of the economy in 1996 is likely to be business equipment spending. Although the 10% expected growth rate in this investment category is below 1995's approximately 15% rate, it is still impressive. Housing investment is likely to be up only slightly, while business construction will likely grow by 4%, albeit still from very low levels as it recovers from overbuilding in the 1980s and the corporate downsizing and consolidation of the 1990s.

The large consumer spending sector is another key to the performance of the overall economy in 1996. Moderate but solid levels of consumer confidence, an increase in real disposable income of 2.3%, modest declines in interest rates, and small but positive wealth effects from the spectacular performance of the stock market in 1995 all presage solid growth in consumer spending.

The international sector will probably continue to grow in importance for the U.S. in 1996. The vote against separating Quebec from Canada and the recovery and stabilization of the Mexican economy, at least haltingly, are good news for the outlook for trade with those key trading partners. Growth will be modest but positive for all major industrial economies. Japan still has serious financial and real estate problems, but the worst is probably over.

The big uncertainty for 1996 is the federal budget. A budget compromise will be reached, of course, and there will be another plan to balance the budget. The new plan will be more credible (and painful) than

its progenitors, but the Holy Grail of *revenue = expenditure* will not be reached until sometime in the future. Ironically, the impact of the plan will be small in 1996 and will probably add to the deficit and contribute fiscal stimuli in 1996, as tax cuts take hold before spending reductions.

Monetary policy will be an area to watch closely in 1996. The Federal Reserve engineered (or watched over, depending on your perspective) a soft landing to the economy in early 1995. Interest rates remain high relative to expected inflation. The Fed is likely to leave them there unless it sees both stronger-than-expected economic growth and what it considers to be an effective budget agreement.

Private Domestic Demand

R. Jeffery Green

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Gross Private Domestic Purchases (PDP) is total demand less government purchases and exports. It is also the sum of consumer and investment expenditures. PDP was just under 85% of Gross Domestic Product (GDP) in 1994. Gross Private Domestic Sales (PDS) is defined as PDP less inventory investment and so represents the sum of consumer purchases, purchases of plant and equipment by firms, and new residential construction. The **Figure** below shows the quarterly movements in PDP and PDS over the past three years.

Figure
Real Private Domestic Purchases and Sales

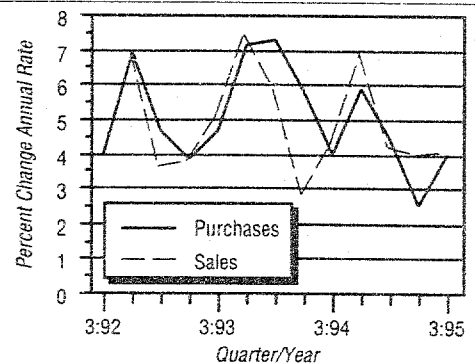


Table
Summary of U.S. Forecast

	1994 (\$billion)	1995	1996
Gross Domestic Product (GDP)	5,344	3.0%	2.5%
Personal Consumption Expenditures	3,580	2.9	2.3
Investment	952	8.7	6.6
Government Purchases	923	-0.3	0.0
Exports	657	10.0	6.8
Imports	767	11.1	7.8

NOTE: All GDP components are in 1987 dollars or are inflation-adjusted changes from the previous year.

Over the last three years, the growth rate for PDP has averaged 4.9%, whereas that for PDS has averaged 4.7%. This is a very strong performance. From 1959 through 1994, growth in PDP and PDS averaged 3.2%. Because consumer spending is an important measure of the standard of living, and because investment spending is important for future growth and productivity improvements, the recent rapid growth of PDP and PDS is great news.

One note of caution is in order. Whenever relative prices change dramatically, our conventional measures of growth, including PDP and PDS, will overstate the actual rate of growth. The large decline in computer prices in recent years has introduced this bias into the conventional measures, and the Bureau of Economic Analysis of the U.S. Department of Commerce plans to release new measures that correct for this bias by year-end. Even with this caution, the new measures will likely continue to show strong growth in PDP and PDS over the last three years.

Consumer Spending

In the last year, real consumer spending rose 3.2%, which was more or less in line with the growth in real GDP. The consumption growth was fueled by a 3.7% rise in real disposable personal income. This was a product of a rise in both real compensation per hour and in hours worked.

The pattern of growth across categories of consumer spending has shown great variation this last year. For example, expenditures on autos have fluctuated greatly from quarter to quarter, but have not shown sustained growth. The level of real spending on autos was lower in third quarter 1995 than in first quarter 1994. Expenditures for furniture and household appliances, on the other hand, have grown 12.4% over the last year in real terms.

Investment Expenditures

Led by a 27.5% increase in real business spending for information processing and related equipment, overall real spending on business equipment rose more than 16% in the last year. This was the main reason private domestic purchases have been so strong. Real expenditures on structures rose 10.2% in the last year, the strongest performance for structures since the commercial real estate boom and bust of the 1980s. Businesses also added to inventories this year with accumulation in excess of \$40 billion over the last year.

The Forecast

What does all this imply for the rest of 1995 and 1996? The economy is now at full employment and inflation remains moderate. We see no great shocks in store for the economy. Even the major fiscal policy moves being contemplated by Congress will not have

much effect in 1996. Thus, we expect continued growth without a recession through the coming year.

Because the economy is at full employment, growth will slow to something like the rate of growth of capacity for the economy, which we estimate is close to 2.5%. Real disposable income and real consumer spending are expected to rise by about 2.3% in 1996. Hence, there will be little change in the saving rate. We expect autos to show steady but not growing demand, with unit sales of new autos averaging 8.9 million in 1995 and 9.0 million in 1996.

Investment expenditures should again lead the economy in 1996, with real spending on business equipment rising more than 10%. Spending on structures will also show some strength, growing at a 4% rate in 1996. The inventory accumulation that was observed through most of 1994 and 1995 should slow in 1996, as the pipeline becomes full and growth in demand slows.

Finally, overall real PDP should increase 3.2%, faster than the growth of overall GDP. This is primarily because the government sector, which is part of GDP but not part of PDP, is expected to show little or no growth in 1996.

Fiscal and Monetary Policy

Carol A. Lehr

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At the time of this writing it remains unclear what form the deficit reduction will assume as Congress and the Administration battle over the final form of the fiscal year 1996 budget. Currently, it appears as though Congress will send to the White House a bill that seeks to balance the budget over a period of seven years, with a combination of tax cuts and deep cuts in projected spending. Though the House has passed a resolution budget, many differences still remain between the House and Senate versions of the budget. It remains to be seen which portions of either version will be contained in the final piece of legislation that will be presented to the President.

However, the major outline of the landmark legislation is similar across the House and Senate versions. The centerpiece of each bill is a cut in the capi-

tal gains tax coupled with a tax credit for children. The versions differ in their income cutoffs for eligibility for the tax credit and the extent of the projected cuts into Medicaid, Medicare, and other social programs. However, both plans contain large cuts in government provision of medical care to the elderly and the poor, as well as declines in Social Security payments.

Whatever the details of the plan, at this juncture it seems likely that the Republicans are going to demand tax cuts, including the child-tax credit and some form of capital gains tax reduction. And there is no avoiding government spending cuts if the budget is to be balanced. However, it is also likely that the tax cuts will precede the spending cuts, meaning that for the 1996 budget year one possible outcome will be a short-run stimulus before the subsequent years' draconian tightening. While some may predict that expected government spending cuts will increase current savings to compensate for future liabilities, I believe that any increase in savings is likely to be small relative to the projected declines in government spending.

The most likely contribution of the budget outcome to economic performance in 1996 will be a modest drag. The positive contributions to spending will come not only from the tax cuts, but also from an increased sense of optimism from a segment of the population that the budget deficit will shrink considerably over the subsequent years. However, there will be other segments of the population feeling increasingly uneasy about their economic future. These include the elderly and the poor, whose real income (which includes government transfers) will decline. When considering that there is already a widespread malaise among the middle-class, who see economic prospects for themselves and their children diminishing, a budget that could spread the pessimism to a wider group of people is not good news for the long term. Furthermore, the budget cuts in their present form include eliminating or significantly cutting back in government contributions to educational assistance, which does not bode well for future economic performance. The future of these programs depends crucially on the administration's political maneuvering and tenacity in the upcoming post-veto battle.

Monetary Policy

Of course, the above discussion on the 1996 outlook due to fiscal policy actions was incomplete in the sense that it failed to account for any reaction to the Federal Reserve. Recently, the Fed has looked favorably on credible actions to lower the budget deficit. Chairman Greenspan has repeatedly linked further interest rate reductions to budget deficit reductions.

Therefore, if the budget resolution gives the appearance of producing significant declines in the

deficit, then monetary policy will most likely react by decreasing interest rates over the long run. Moreover, as government borrowing needs fall, the market itself will adjust to lower credit demand by pushing down yields. A further stimulus to lower long-term interest rates could result from lower inflationary expectations engendered by the contractionary fiscal policy.

However, for 1996 the path of interest rates will also be influenced by the state of economic growth and other inflationary pressures. The 1995 environment has been one of almost surprisingly low inflation, coupled with decent output growth rates. While the preliminary third quarter GDP growth numbers were high relative to expectations, it is not likely that the overall annual growth rate for 1995 will continue at that pace. When the Fed's policy-making committee next meets, chances are it will react cautiously given third-quarter growth numbers and the uncertainty surrounding the budget scenario. So the next likely Fed-induced interest rate change will not come until 1996, at which time there will be more information available on fourth quarter economic performance, as well as the fiscal stance.

In summary, as long as fourth quarter indicators are not too strong and deficit reduction continues at its current pace, the scenario is favorable for a modest decline in both short- and long-term interest rates over the 1996 calendar year.

The International Economy

Michele Fratianni

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Economic growth around the world improved in 1994 and has kept pace in 1995. **Table 1**, based on data available in May 1995, indicates that world output is now growing above long-run trends. This performance, in turn, reflects the fact that several industrial countries are in the expansion phase of the business cycle, while developing countries as a whole continue to grow twice as fast as the industrial countries. Of the so-called G7 countries (the elite of the industrial countries, which account for a large share of world output), only Japan is falling below the trend.

Table 1
Growth of World Output, 1977 to 1995

Average	1977-86	1991	1992	1993	1994	1995 (est)
World	3.4	1.3	2	2.5	3.7	3.8
Industrial Countries	2.7	0.8	1.5	1.2	3.0	3.0
United States	2.7	-0.6	2.3	3.1	4.1	3.2
Japan	4.0	4.3	1.1	-0.2	0.6	1.8
Germany	1.9	2.8	2.2	-1.1	2.9	3.2
France	2.2	0.8	1.2	-1.0	2.5	3.2
Italy	2.7	1.2	0.7	-0.7	2.5	3.0
United Kingdom	2.1	-2.0	-0.5	2.2	3.8	3.2
Canada	3.1	-1.8	0.6	2.2	4.5	4.3
Developing Countries	4.6	4.9	5.9	6.1	6.3	5.6
Asia	6.9	6.4	8.2	8.7	8.6	7.6

Source: International Monetary Fund, *World Economic Outlook*, May 1995.

Table 2
The *Economist* Poll of Forecasters—October Averages

	Real GDP 1995	% Change 1996	CPI 1995	% Change 1996	C.A. balance 1995	% of GDP 1996
United States	3.0	2.5	3.0	3.1	-2.3	-2.1
Japan	0.4	2.0	-0.1	0.2	2.3	2.0
Germany	2.5	2.8	1.9	2.2	-0.9	-1.0
France	2.9	2.6	1.9	2.3	1.1	0.7
Italy	3.1	2.8	5.4	5.2	1.8	1.9
United Kingdom	2.8	2.8	3.4	3.5	-0.7	-0.8
Canada	2.2	2.5	2.3	2.5	-2.6	-2.2

Source: *The Economist*, October 14, 1995.

The United States, Canada and the United Kingdom have been in an expansion phase since 1992; Germany, France, Italy, and Japan, since 1994. Hence, the three English-speaking countries lead the other four countries by approximately two years and are more likely to experience flattening or even a reversal of economic growth. There are no signs of an impending recession, however. The consensus of the forecasters polled by the weekly *Economist* is that the "real economies" of the U.S., Germany, France, Italy, the U.K., and Canada will expand at approximately the same rate as in 1995 (see **Table 2**).

Japanese growth will improve in 1996. Nevertheless, this economy continues to underperform relative to its long-term trend. The factors at work are the deflation of the real estate price bubble, the deterioration of the quality of bank assets, the sharp slowdown of Japanese exports following an appreciating yen, and pressures on Japan to reduce its current-account surplus. The restructuring process from an export-oriented to a domestic-oriented economy is slower than anticipated and is responsible for part of the economic slowdown. But another reason for Japan's

poor performance has to do with a lethargic economic policy that has failed to recognize the importance of a healthy financial system for the economy as a whole. Unlike the U.S., which took stock of the gravity of the S&L crisis and took appropriate action, the Japanese authorities have tried to buy time, hoping that banks and financial firms would grow spontaneously out of the crisis.

Although there is no plan for rescuing Japanese banks, the monetary policy action taken in September of this year suggests that the Bank of Japan and the Ministry of Finance have come to the conclusion that the "time buying" strategy was not working. The Bank of Japan reduced the discount rate to an all-time historical minimum of 0.5%. The expansionary monetary policy has reduced the probability of major bank failures and will have a positive impact on economic growth in the next 6 to 12 months. Fiscal policy is also expansionary. In sum, economic policy seems to have lifted a weight on Japanese growth.

The 15 countries of the European Union (EU) are preparing for European Monetary Union at the end of the century. Membership in the union is not automatic, but rather depends on meeting convergence benchmarks of inflation rates, interest rates, government debt, and government budget deficits. The vast majority of the countries are "way off" these convergence benchmarks, especially those concerning public finance. A few countries, such as Belgium and Italy, have debt-to-GDP ratios that are more than twice as large as the required ones. In an attempt to satisfy the convergence criteria, EU governments will have to implement restrictive policies that would undo some of the effects of the fiscal profligacy of the 1970s and the 1980s. Failure to implement corrective fiscal policies is bound to exacerbate the consequence on future generations of citizens.

France is a good example of this conflict. Adherence to the convergence benchmarks requires a tight fiscal policy. Yet a tight policy will raise the already high unemployment rate in France. Democracies have tended to postpone severe economic adjustments simply because future generations of individuals do not vote and are not adequately represented by current generations. Democracies, furthermore, have found it easier to raise taxes than to cut the growth of public spending. Higher tax rates reduce budget deficits only temporarily. As time goes by, the growth of public spending creates larger deficits and renewed calls for higher tax rates. The relative size of government is such that the correction cannot be postponed for many more years.

Inflation rates in the industrial countries remain at historically low levels (below 3%). Those in the developing world, which have been much higher historically, are still coming down. In the fast-growing

Asian countries, inflation rates average about 7%. Low rates, in turn, enhance the prospects of a protracted expansion phase of the business cycle.

Short-term rates of interest have fallen in Germany and Japan, are rising in Canada, France, Italy and the U.K., and remain approximately the same in the United States. Long-term interest rates are higher than short-term rates in virtually all industrial countries. The positive spread between long- and short-term rates is typical of an expansion phase of the business cycle and can be interpreted as a market forecast that future short-term interest rates will be higher than they are now. Long-term interest rates in the G7 countries range from a minimum of 2.9% in Japan to a maximum of 11.5% in Italy.

Given the high degree of capital mobility among industrial countries, real rates of interest cannot diverge too much from one another. Assuming a real rate of interest of 3%, we can infer that expected inflation is very contained in the industrial world. While the average is low, the dispersion is still relatively large. For example, the markets view Japan's expected inflation as nonexistent, whereas Italy's expected inflation is approximately 8%.

Since 1985 the U.S. government, both alone and in cooperation with the other members of the G7 group, has pursued a policy of dollar depreciation with the aim of correcting its external imbalance. Furthermore, it has progressively engaged in an active trade policy, particularly with respect to Japan. The motivation underlying this policy is the belief that the U.S. has a trade deficit because other countries—but especially Japan—do not play "fairly." This is a misguided concept. Our trade deficit has little to do with unfair trade practices and a great deal to do with the fact that the U.S. saves too little relative to its investment needs. Trade deficits will persist so long as the saving/investment imbalance remains. Further devaluations of the dollar and a more aggressive trade policy are a minor force in rectifying our trade deficit.

Table 3 presents a summary of our forecast.

Table 3
Summary of International Forecast
(In Billions of 1987 dollars, NIA Avg.)

	1995 <i>Estimated</i>	1996 <i>Forecast</i>
Exports	730	794
Imports	847	914
Net exports	-117	-120

Capital Markets

Michael Simkowitz

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 Indiana University School of Business*

The stock market continues to climb a wall of worry. Most of that worry is generated by your author, who is concerned as to whether he did not sell some stocks too early. The market's action over the last 12 months has been quite impressive, but more about the stock market later.

Our forecast is calling for a rather quiet year on the economic scene. Since growth should continue at much the same rate as the long-term capacity of the economy, it is not surprising that we are looking for interest rates to remain approximately where they are. This means we expect long-term treasury bonds to remain in the 6-1/4 to 6-5/8 range and for 90-day treasury bills to decline by 1/4 to 1/2 point from their current levels of 5.5%.

The weakness of the Japanese and German economies means foreign rates should not be aggressive competitors for investment. This will allow the Fed to determine policy mainly on domestic factors.

The outlook for corporate earnings is not quite as sanguine. Earnings have grown at a rather impressive rate in 1995. The operating earnings for the Standard & Poors 500 should be up approximately 14% over 1994. But in looking ahead at next year, it appears that operating earnings for the S&P may struggle to manage a 4 to 5% growth. A very large part of the improvement of U.S. corporate earnings over the past few years has been the result of an extremely successful campaign of cutting costs, primarily in the area of overhead. The downside of improving earnings through cost-cutting is that there is a definite limit to how low one can cut costs.

This reminds me of the story of a man who came upon a farmer with a cart that had been pulled by a horse. The horse was still in its traces, but was lying dead in the road. The man asked the farmer what the problem was and the farmer replied, "Well, I thought I had a good thing going. About a year ago I began to cut back on the horse's feed, fed him a little less each day, and he continued to work just fine. Finally, last week I got down to where I wasn't feeding him at all, and just then the darn thing died on me!" There is both a moral and a lesson here for corporate management as to how far one can cut costs before the horse dies.

The last two months have been characterized by more downward revisions of earnings than upward

revisions by analysts. If we look at the pattern, we see there was a sudden surge in the number of upward revisions of earnings starting back in October 1994—coinciding with the beginning of this most recent leg of the bull market. The upward revisions quickly reached their peak toward the end of November 1994, and since then we have had more downward revisions than upward, though the pattern has not been a steady one. However, in early September 1995 the number of downward revisions caught up and surpassed the number of upward revisions. What we are seeing is the end of this leg of the bull market, which to a great extent was driven by the surprisingly good earnings in early 1995.

The other and very major impact on the market for the last few years (especially the past 18 months) has been the virtual flood of money from individual investors coming into the market. The primary vehicle for this has been mutual funds, and a large volume of the money is in 401k plans. Investors will be slow to alter their commitment to their 401k plans; when they do, it will not be to reduce their contributions but possibly to reduce their commitment to equities. It is interesting to note that as American pensions shift slowly but steadily from defined benefits to defined contributions (i.e., 401k plans), the flow into the capital markets becomes steadier. Corporate pension contributions are notoriously irregular. Keep in mind that corporate plans can become underfunded and that the determination of proper funding is subject to some manipulation of the assumptions of interest rates and expected returns. The net result is that, to a great extent, corporations can make the actual transfer of funds to the pension fund when it is convenient for them, as opposed to doing it every quarter or every month or even every year. But the 401k plans and their potential matching contributions by the employer are much steadier. This institutional structure is relevant when we think about what some of the risks are to our forecast.

It is our general consensus that the forecast is subject to more downside risk than upside risk. In other words, we believe there is a large chance that the growth may be less than what we are forecasting. If that is true, corporate earnings would struggle to show much positive growth, at least for the S&P 500. Under that scenario, we could see the investor begin to pull away from equity markets. At the same time, the slowness in the economy will most likely encourage the Federal Reserve to increase the growth in money supply and reduce interest rates. If we are right that the 401k money will not decline in the aggregate, but possibly switch from equities to bonds, this will allow the Fed to reduce interest rates quickly; thus, the market would be receptive as some of the 401k money that is pouring into equities is diverted

into bonds. The net result will be that any decline in the stock market will be dampened by a significant decline in interest rates, which should help stabilize the stock market.

Although our best forecast is for long-term rates to be fairly stable and short-term rates to decline slightly, if the economy does weaken we could see an additional 50 basis point drop in short-term rates and possibly a 60 basis point drop on long-term rates.

In summary, long-term investors should stay strongly committed to the equity market, though they may want to be cautious about adding to their positions, keeping some powder-dry to take advantage of any market corrections. These market corrections should, at most, be in the 15% range from current levels, with the Dow Jones now at 4750 and the S&P 500 close to 580.

Housing

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The outlook for housing is much better than it was one year ago. At that time, mortgage rates had just risen about 200 basis points from the previous year, 1993, when they hit a 28-year low. Mortgage rates have fallen again this year (**Figure 1**), though not quite to the level reached two years ago. This decrease has pushed sales of previously owned homes to a 4.15 million annual rate, which is up 7.2% from last year—a leap that represents five months of consecutive increases in home sales.

Pent-up demand from the early 1990s recession had helped propel single-family housing starts over the one million unit mark during 1993-94. But we have remained at that level through 1995 and will probably remain there through the coming year. The good news is that the principal home-buying age group, those aged 35 to 54, has expanded by 10 million people during the first half of the 1990s, implying continued demographic support for this market. Thus, although a significant increase in single-family housing starts is not likely, a decrease is equally unlikely.

Figure 1
Mortgage Interest Rate Time Series, 1994-1995

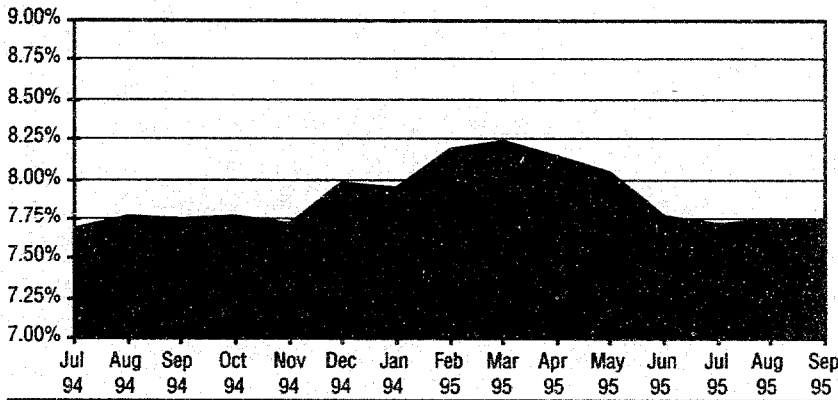
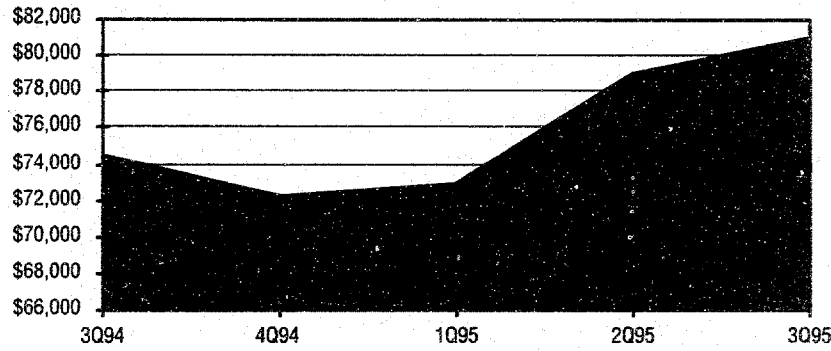


Figure 2
Median Home Price, 1994-1995



Multi-family housing starts have benefited from the increased availability of capital from banks and other sources, such as real estate investment trusts (REITs), for new construction. Although the decrease in mortgage rates has lured some people to own rather than rent, multi-family housing starts will likely remain at the current level. Total housing starts (single and multi-family) will probably remain flat during 1996, at an annual rate of about 1.4 million units. Housing starts peaked at 1,972,000 in January 1972 and reached a low of 837,000 units in late 1981.

Last year, to mitigate the rise in the rate for fixed-rate mortgages, many borrowers took advantage of the steep yield curve by choosing adjustable rate mortgages (ARMs) rather than fixed-rate mortgages. As rates fell this year, borrowers switched back to fixed-rate mortgages and the percent of ARMs dropped from 60% a year ago to 23% in recent months. This is expected, given the narrower gap between ARM and fixed-rate mortgages we see in the current market.

The median home price in Indiana (Figure 2) was \$79,500 during second quarter 1995—an increase of almost 9% from second quarter 1994. This compares to a slight decrease in the median home price for the nation during the same time period. The median price in Indiana is still considerably less than that for the rest of the nation—\$109,000 for second quarter 1995. The gap between home prices in Indiana and those of the U.S. suggests much room for growth, which we have predicted for several years and which has been coming true.

