



Merage School Dean Andy Policano sets the stage for the coming economic year in his annual address January 29, 2009, at the Irvine Chamber of Commerce breakfast meeting. Herewith is a summary of his insights and commentary.

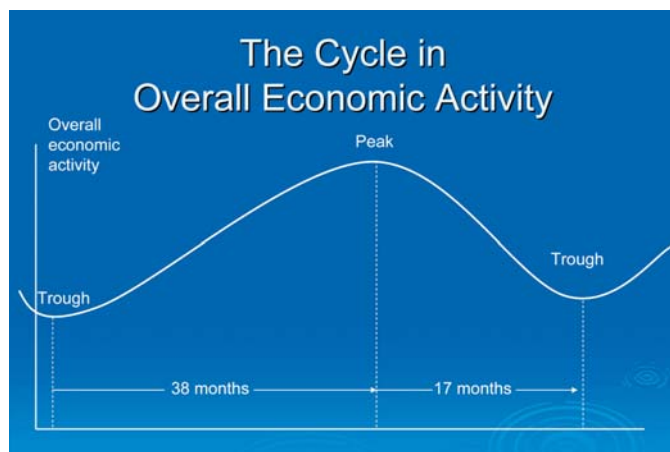
THE ECONOMIC STORM

WHAT IS HAPPENING?

- GDP Growth is down; will be negative in 2009
- Unemployment is above normal and rising
- Inflation – both core inflation and the Consumer Price Index – is dropping
- Defaults decrease financial sector liquidity
- Increases upward pressure on interest rates
- Loss of confidence in financial sector leads to reluctance to lend
- Consumers and companies decrease spending due to loss of confidence
- Decreases in production result, layoffs follow

WHY IS IT HAPPENING?

- New exotic derivatives (such as Credit Default Swaps (CDSs))
 - ❖ Seller provides insurance to borrower for buyer's loans
 - ❖ Estimated \$33 trillion to \$60 trillion worth of CDSs
- Relaxation of regulatory oversight
 - ❖ Decline in reserve ratios
 - ❖ Repeal of Glass Steagall, which prohibited investment banks from having deposits
 - ❖ Largely unregulated credit default swaps
- Inaccurate ratings of derivative assets
- Credit Default Swaps problematic
 - ❖ Congress prohibited them after Great Depression
 - ❖ Congress changed in 2000
 - ❖ Agencies incorrectly assessed risk of CDSs
 - ❖ Didn't need to own an asset to buy insurance
 - ◆ Default on loan can lead to multiple payouts



HAS THIS TYPE OF "PANIC" HAPPENED BEFORE?

- Panics in U.S. date back to at least 1792
- At least 16 banking panics since 1814
- Between 1854 and 2001, 32 cycles
- Average expansion from bottom to peak is 38 months
- Average downturn from peak to trough is 17 months

IS ANYTHING DIFFERENT TODAY?

- A broader impact on financial markets due to derivatives
- But we're smarter today
 - ❖ Monetary policy is flooding markets with liquidity
 - ❖ More safeguards in place
 - ❖ Therefore, less impact than Great Depression
 - ❖ In recent history:
 - ◆ The number of cycles per decade has decreased
 - ◆ Duration of downturns has decreased
 - ◆ Duration of expansions has increase
 - ◆ HOWEVER: WE HAVEN'T FACED A CHALLENGE AS SEVERE AS THIS SINCE THE GREAT DEPRESSION

WHAT ARE WE FACING?

- Under normal circumstances, the Federal Reserve:
 - ❖ Increases money supply by buying T-bills
 - ❖ Forces rates down
- In Sept. '07 Fed began lowering rates
- In Dec. '08 dropped to essentially zero
 - ❖ However, current dysfunctional financial markets are limiting Fed's power
 - ❖ Financial institutions have weak bank balance sheets
 - ❖ Freeze in the credit market/lack of lending
 - ❖ Large loss of wealth leads to lack of spending
 - ❖ Loss of confidence leads to lack of borrowing, lending and spending
 - ❖ "The Paradox of Thrift:"
 - ◆ Normally, saving is a good thing
 - ◆ But if everyone saves, it leads to:
 - A decrease in spending
 - A recession (meaning income falls, then saving falls)

WHAT IS THE GOVERNMENT DOING ABOUT IT?

- Estimated \$2 trillion to:
 - ❖ Rescue Bear Stearns, Citigroup
 - ❖ Raise federal guarantees on money market funds
 - ❖ Boost commercial paper market
 - ❖ Purchase mortgage-backed securities
 - ❖ Rescue AIG

- TARP (Troubled Asset Relief Program), known as “bailout”
 - ❖ Buy stressed assets, taking them off balance sheets
 - ◆ But banks first will increase reserves with the TARP funds
 - ❖ Add equity via government taking ownership positions
 - ❖ Second half of TARP money release, but with more oversight than first half

WHAT ELSE SHOULD THE GOVERNMENT DO?

- Fiscal stimulus
- Government is “spender of last resort”
- Fiscal stimulus package needs to be:
 - ❖ Timely, Large, Lasting, Diversified, Contingent, Sustainable
- Pres. Obama’s Plan:
 - ❖ \$300 billion tax cut for low/middle income workers
 - ❖ Cut payroll taxes to lower wage costs and increase hiring
 - ❖ Increase investment tax credit to increase capital expenditure
 - ❖ Spend between \$300 billion and \$400 billion on infrastructure
- Will it work?
 - ❖ Romer/Bernstein study from Pres Obama’s administration
 - ◆ Without a plan, unemployment will be 8.8% by end of 2010
 - ◆ With the plan, it will rise throughout 2009 and slowly fall back to 7% by the end of 2010
 - ◆ Unemployment is a “lagging” indicator; economic activity will pick up prior to improvement of the unemployment rate

WHEN WILL THE BAD NEWS STOP?

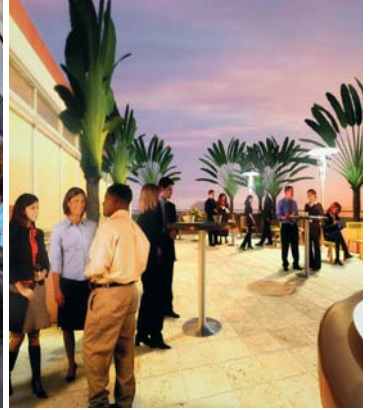
- Already some positives:
 - ❖ Energy prices are down
 - ❖ Interest rate differentials closed after Fed intervention
 - ❖ Mortgage rates falling
 - ❖ Commercial paper activity has increased
 - ❖ Consumer confidence is up
- However:
 - ❖ Commercial real estate will be next sector to produce bad news
 - ❖ State budgets all over the country are in crisis
 - ❖ Depth of global fiscal crisis is still unknown
- Outlook for next 6 to 9 months is bleak
 - ❖ Consumer spending/consumption will continue to be down
 - ❖ Layoffs will continue
 - ❖ Unemployment will increase
- Signs to watch for that will signal economic recovery:
 - ❖ Good news from Index of Leading Economic Indicators
 - ❖ Declines in housing inventories (currently at 11-12 months)
 - ❖ Fall in interest rate differential between LIBOR and 3 mo. T-Bill



- ❖ Recovery of consumer confidence
- ❖ Improvement in employment hours
- ❖ Stock market recovery, which normally leads economy by 6-8 months
- Based on history, a reasonable estimate is that the trough will occur in late 2009
 - ❖ Unemployment will rise to 7.8% to 8.3% in 2009
 - ❖ GDP growth will be negative (-1.2% to -2%) in 2009
 - ❖ Inflation between .75% and 1.25% in 2009
- Recovery will be slow
 - ❖ Unemployment will fall to 7% in late 2010
 - ❖ Return to normal by 2012-2013

WHAT WILL THE WORLD LOOK LIKE THEN, ONCE THIS IS OVER?

- The end of “behemoth” banking
 - ❖ Breakup of Citigroup
- Increase in regulation
 - ❖ Finance industry was too large
 - ❖ Less risk will be undertaken, leading to slower but more stable growth
 - ❖ Shifting world economic strength
- In the long term (3-10 years):
 - ❖ U.S. will be paying for the cost of the current policies
 - ❖ Some debt will be repaid by increasing growth
 - ❖ U.S. citizens should expect:
 - ◆ Higher taxes
 - ◆ Higher inflation
 - ◆ Slower growth
 - ◆ Higher Interest rates
- Ethics – ala the Bernie Madoff scandal – must be addressed
- U.S. must solve underfunding of Social Security and Medicare



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Showcased within the walls of new Merage School building will be the stories of our region's leading businesspeople, companies and philanthropists, brought to life through technological "memorials" that will tell the history of Orange County's innovators, experts and leading citizens.

Rooms within the building will display our community's vibrancy and success. From a 21st century, technology-inspired auditorium to an executive boardroom and other conference rooms that will host the region's business leaders; from colloquia and case study rooms to an inviting atrium and community meeting area; every space in the new building will showcase a vital member of our community.

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