FORUM facts
A publication of The International Forum
Fall 2008

Economic Think Tank Scholars to Report on Global Economic Outlook

Moderator

Terry R. O'Neill
President, CEO
The O'Neill Company

Panelists

James R. Barth
Senior Finance Fellow
The Milken Institute

Ross DeVol
Director of Regional Economics and the Center for Health Economics
The Milken Institute

Joel Kurtzman
Senior Fellow
Executive Director of SAVE
The Milken Institute

Perry Wong
Senior Managing Economist in Regional Economics
The Milken Institute

Glen Yago, Ph.D.
Director of Capital Studies
The Milken Institute

This year has been punctuated by unprecedented economic changes giving rise to unique challenges and opportunities. We have witnessed a cascade of unforeseen economic events: the housing bubble burst, the takeover of Fannie Mae and Freddie Mac, acquisition of Bear Sterns and Merrill Lynch and the nationalization of AIG. How will the sea of economic changes affect our services, clients and businesses?

While the answers to these questions are still being determined, The International Forum is working hard to pull together sources of information and forums to facilitate discussion of these pressing events. Foremost among these is The International Forum 2009 Annual Meeting being held January 24-28, 2009 at the Hyatt Regency Century Plaza in Los Angeles, California. During Monday's general session, International Forum member and past president Terry O'Neill, will moderate a panel of five economic scholars: James R. Barth, Ross DeVol, Joel Kurtzman, Perry Wong and Glen Yago, Ph.D., who arguably offer a less biased, more independent economic vantage point than private sector economists so often quoted in media outlets. The panel of scholars all hail from the Milken Institute, recognized as one of the nation's leading independent economic think tanks.

The mission of the Milken Institute is to improve the lives and economic conditions of diverse populations in the United States and around the world by helping business and public policy leaders identify and implement innovative ideas for creating broad-based prosperity. The institute puts research to work with the goal of revitalizing regions and finding new ways to generate capital for people with original ideas.

The Milken Institute does this by focusing on *human capital*—the talent, knowledge and experience of people, and their value to organizations, economies and society; *financial capital*—innovations that allocate financial resources efficiently, especially to those who ordinarily would not have access to it, but who can best use it to build companies, create jobs and solve long-standing social and economic problems; and *social capital*—the bonds of society, including schools, health care, cultural institutions and government services, that underlie economic advancement.

The panel will discuss the financial and economic ramifications surrounding several domestic and global challenges including:

- Current domestic economic headwinds and how to build a U.S. recovery
- Global energy issues
- Credit crises, interest rates and the state of global real estate
- Financial innovation, regulation and over-regulation
- United States and global economic decoupling
- Financial retirement shortfalls, longevity risk and chronic disease
- Human capital, financial capital, social capital and their democratization
- The new age of authoritarianism, global terror and geopolitical events
- Basel II
- Doha
- IFRS effects

"This impressive and outstanding panel couldn't have been accomplished without Terry O'Neill, Forum member and 1995 past president," commented Clarke Langrall Jr. 2009 Annual Meeting Program Co-Chairperson. "Terry is very involved with global economics and has been nominated four consecutive years to serve on the Consumer Advisor Council for the Board of Governors of the Federal Reserve. Considering the economic times we are currently experiencing, the world-class panel Terry has assembled will provide us with insight that few in our industry can access. Attendees will gain a better

continued on page 7

This issue's contributed article:

Economic Think Tank Scholars to Report on Global Economic Outlook

continued from front page

understanding of the national and global economic perspectives, which they can leverage to benefit themselves and their clients."

"This isn't the first time Terry arranged for a high-level speaker at the Forum Annual Meeting. In 2005, Terry and his wife, Ssusan O'Neill, asked their personal friend, the late Dr. Edward Gramlich, Federal Reserve governor, to speak at the Forum Annual Meeting. Dr. Gramlich is famous for accurately predicting the current U.S. economic credit and sub-prime housing crises. Terry's desire to expand economic and financial literacy in addition to his commitment to the Forum is eminent through his dedication to organizing and providing speakers such as Dr. Gramlich and the Milken Institute Panel," concluded Langrall.

At the general session, moderator O'Neill will address the current decline of residential real estate prices. He views this decline as a natural result of the bubble that by 2006 had raised house prices to 60 percent above their long-term trend. Yet his research indicates that even with the sharp decline in pricing, today's prices are still about 15 percent above the trend level. But while a further 15 percent decline may be inevitable, O'Neill cautions that despite the actions taken to restore liquidity to the financial industry, there is no guarantee that these actions will stop prices from declining even further. House prices that could overshoot by 60 percent on the way up could also overshoot substantially on the way down. During the past 12 months, house prices across the nation fell by an average of 16 percent. The large overhang of unsold homes continues to create pressure for further price declines. The record level of defaults and foreclosures continues to add to the stock of unsold homes. Potential house buyers who foresee continued foreclosures are reluctant to buy now because they anticipate future price declines.

O'Neill notes that it remains uncertain whether or not the enacted and proposed policies will permit the appropriate 15 percent additional decline in house prices but remove the risk of a further downward spiral. The fear of continued mortgage defaults and house price declines is depressing the prices of mortgage-backed securities and of the derivative products based on them. This fall, in turn, is causing large losses at commercial banks and other financial institutions.

Because of the uncertain values of mortgage-backed securities, financial institutions lack confidence in the liquidity and solvency of counter-parties and even in the value of their own capital. Without that confidence, there cannot be adequate credit flows and without credit there cannot be economic activity and growth. With the U.S. Treasury's proposal to buy these mortgage-backed securities, it is hoped that credit flows will become more regular.

Mortgage-backed securities cannot be valued with any confidence until there is more certainty about the future of house prices. The precariousness of the situation reflects the very high ratio of individual mortgage balances to the underlying current house values. Because of the decline in house prices that have already occurred, more than 10 million home owners now have mortgages that exceed the values of their homes. This is 20 percent of all homeowners with mortgages. For half of that negative equity group, the debt exceeds the house value by more than 20 percent. If house prices fall another 15 percent, negative equity mortgages will rise to 20 million.

Negative equity mortgages are a big source of instability because U.S. home mortgages are generally "non- recourse" loans, implying that if an individual defaults on his mortgage the creditor can take the property but cannot claim other assets or income to pay the remaining loan balance.

The large and growing number of homeowners with negative equity will increase the rate of defaults and foreclosures and therefore drive the downward spiral of prices. Defaults are likely to accelerate as the ratio of the debt to the home value rises. While a homeowner who owes 10 percent more than the value of a house may continue to service the mortgage, when the excess debt reaches 30 percent the chance of default is much more likely. Each such default puts downward pressure on existing prices, increasing the likelihood of further defaults. It is this spiral that threatens the American economy and the global financial system.

O'Neill feels that the policies adopted by the time of publication on September 27 were not adequate enough to stop the downward price spiral. Although the Federal Reserve has reduced the overnight interest rate from 5.25 percent a year ago to 2 percent now, mortgage interest rates are now higher than they were a year ago. The Treasury's program to encourage voluntary mortgage renegotiations has had little effect, because most mortgages have been securitized and are no longer held by the originating institution. The recently enacted housing legislation is expected to help 400,000 negative equity homeowners, less than 5 percent of the 10 million who have negative equity, and does nothing to stop the defaults among the millions more who will be pushed into negative equity if prices continue to fall.

Some pundits feel the U.S. economy is sliding into recession. Employment, industrial production and real incomes are declining. Monetary policy has little traction because of the dysfunctional credit markets and the collapse of housing. The fiscal policy of tax rebates only resulted in a minor impact on consumer spending. The economy will continue to decline and the financial markets to deteriorate unless a policy is adopted to stop the downward spiral of house prices.

Attendees of the Annual Meeting will become more economically-informed enhancing their capability to direct clients through the financial headwinds. After the general session, attendees can initiate informal discussions with the panelists during the event lunch. Register online at www.int-forum.org on or before Friday, November 14, 2008, and save $300 off the regular member registration rates. Please note: you must renew your membership before registering.* (See editor's note.)

*Editor's Note: *The membership production requirement for 2009 is $500,000 of annual personal financial service income earned in 2008 (Grandfathered members excluded). Due to a 400 member cap, we strongly recommend beginning the renewal process to reserve a membership slot now even if you cannot document the production requirement yet. The membership renewal and Annual Meeting registration deadline is Friday, December 19, 2008. No onsite registrations will be accepted.*