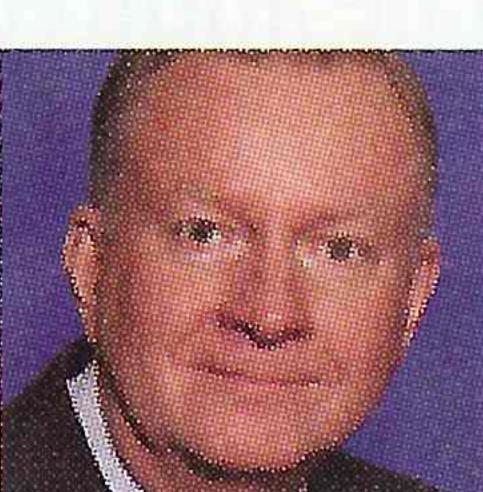
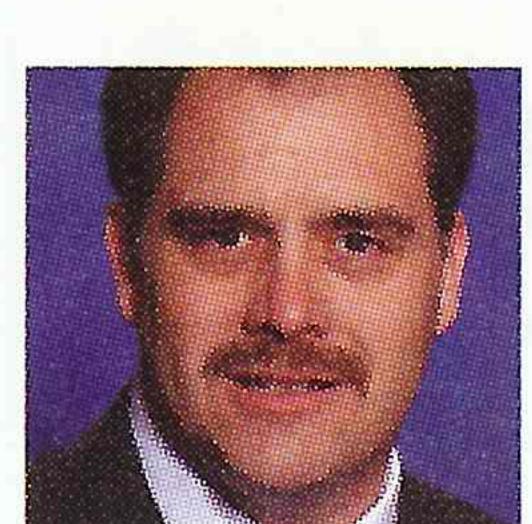
Conditions that had been building for years finally coalesced to send a financial tsunami over the U.S. economy. Listen in as a quintet of **Auburn University experts** provide an economic weather report—and the hint of a rainbow in the long-term forecast.

Perfect Storm

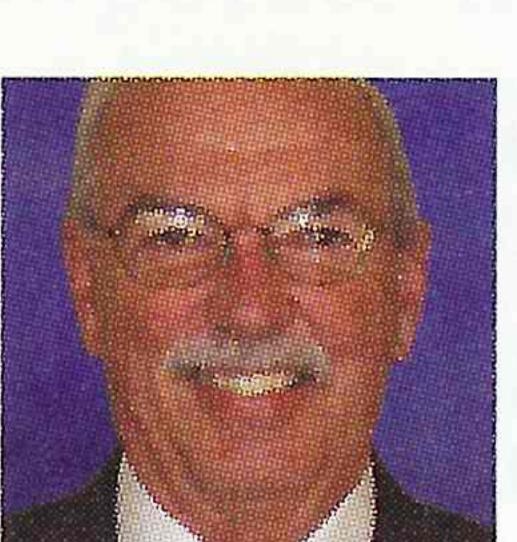
The five professors contributing to *Auburn Magazine*'s panel discussion on the state of the national economy teach in Auburn's College of Business. The college was cited last year as one of the "Best Business Schools" in the nation, according to *The Princeton Review*.



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Distinguished Professor
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Professor of Economics
EXPERTISE Financial
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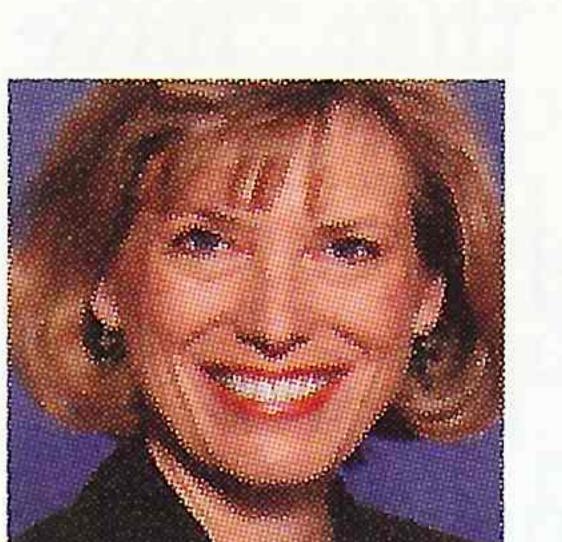
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MERTISE Risk management, investments,
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Beverly Marshall
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EXPERTISE Corporate
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corporate governance



Keven Yost

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EXPERISE Bankruptcy,
financial distress

Storm clouds gather

How did we get here?

Reserve aggressively pushed interest rates down and touched off a real spike in housing prices. At the same time, there was also political pressure to change the criteria for mortgage lending. So 'how we got here' was political pressure, cheap money, rising housing prices and people qualifying for mortgages who, in retrospect, really shouldn't have.

big move to increase home ownership. Home ownership is a thing to be desired, of course, but not everyone can afford it. But the incentives were there to continue making mortgages for less-creditworthy individuals. To enable them to get into homes, we saw a gigantic increase in adjustable-rate mortgages. A lot of people were stretched to the limit at the time they got their loans, and then two or three years down the road when the rate adjusted upward and their payments

went up \$300 or \$400 a month, they found themselves unable to make their payments and defaulted.

There's another factor, too, and that's rising energy prices. When you go to fill up your tank with gas and it costs you \$60 instead of \$20, it puts a lot of pressure on your income. If you were already on the margin, that was enough to tip it the wrong way.

Rising energy prices made the problem worse than it would have been otherwise.

Thunder rolls

Now we're officially in a recession. Will we go into a depression?

DG The difference between a recession and a depression is really one of degree. I don't think that we're going to see anything like the Great Depression of the 1930s, where a third of our workforce was unemployed, but our economy has been so good for so long that people become alarmed when they start seeing unemployment going up and the economy slowing down the way it has this year.

KY There also are different degrees of recession. We've had some economic downturns in the past that were shorter in duration and not quite as painful as the one we're in now.

JH The danger this time is that we may have too much intervention. We may do some things that are hard to undo. In the past, we've had a lot of recessions, and they've been short except for one, which we called the Great Depression. And that is the one where we had the most government interference in the private economy. Many of us worry quite a lot about the intervention into the private economy because it really results in a misallocation of capital.

JJ I think this situation is a little different from past recessions in the extent to which it has spread around the world. to malke We've had financial crises that have affected regions, but to see something Sure we are zoom around the world and affect so many countries and so many economies so quickly, I think, really surprised a lot of people. Of course it also speaks to how interconnected we all are.

BM It also shows how much our economies are going in sync. We're supposed to have some diversification from being invested globally, but we also share the risk—and the downside of sharing all that risk is that everybody gets pulled down.

The maelstrom

Bailouts or bankruptcy?

DG Earlier this year, we saw the federal government make some choices about who they were going to rescue and who they were going to let go down. That caused tremendous uncertainty in the financial markets, because if the government isn't going to rescue anybody, then companies know they have to deal with their own problems. If the government industry? And do we want our political

is going to rescue everybody, companies | leaders running an industry? That's not know they have a way out. When the what they're elected to do. Federal Reserve stood by and let some institutions go down and then stepped in to help others, it created a huge amount of uncertainty. Now we're seeing the federal government jump in and start programs that are going to be with us for a long, long time. Unfortunately, relatively few of our elected officials are standing back and asking if we should really be spending our money this way. Should we really be getting involved in the automotive industry? And if we're going to step in there, what about all the rest? Why not retail? Why not tourism? Why not other types of industries? And who really thinks the federal government is somehow going to be able to straighten out any particular industry?

We meed to provide stimulus to the economy, but we need not setting a slippery slope for the taxpayers are going to have to handle.

JJ We've seen the hearings on the auto industry talking about all the conditions and terms. But a lot of people are skeptical when they look at the performance of Congress itself in the last few years. Can they really run the auto

JH The argument those in favor of bailouts use is that we're about to fall off the cliff—if General Motors goes down, can you imagine all the unemployment? How will we ever recover? They say we should just get through this period and then we'll go back to our free-market principles and things will be fine. What they overlook is the issue of "moral hazard," which says that you'll never get back to the same place. If the government says a company is too big to fail, that company will eventually take on too many projects and be right back where they started, only the next bailout will be for more money.

KY People also have a tendency to hear the word bankruptcy and think it means a business is going to shut its doors. Really, bankruptcy is just a legal process for resolving financial distress. It allows the firm a crack at coming up with a reorganization plan that then has to be approved by all of the parties that are owed money. So if an automotive company were to declare bankruptcy, it doesn't mean the company would disappear; it just means it would restructure its debt, perhaps, and then there may be some other downsizing.

JH But it does give them leverage for renegotiating union contracts.

KY The indirect costs of bankruptcy are real. A bankrupt company will probably downsize. And sales will suffer—people may not want to buy a car from a company they don't think is going to be around. But bankruptcy doesn't mean they're going to liquidate and go out of business.

Slow-moving front

What are the lessons we should be learning from this economy?

KY We forget about the downside of investments sometimes. The economy was strong, investments were doing well, and some people were buying houses bigger than they could afford and others were investing in risky things because everything was working out and they were being rewarded for taking that risk. But "risk" means that it's not always going to work out, and I think people are now getting a taste of that. It's hard, but you expect something good will come out of it. Maybe people will start to realize they need to budget more cautiously. They need to evaluate risk better than they

have, making sure their investments are diversified and making sure their housing isn't comprising too much of their investment. People are reassessing, and that's not necessarily a bad thing. That's a very hard reality but, overall, at a macro level, it's not bad for the country to get a dose of what risk really is.

DG What's happened in the last few months is the loss of a couple of trillion dollars of American wealth, and this comes from two primary areas: the wealth that individuals had in the stock market, much of it in retirement accounts, and the equity they had in their homes. They still owe on their mortgage but now their equity has gone down, so that's a big chunk of what they thought of as their savings. And in many cases their retirement accounts are their stock portfolios. If I used to have \$300,000 in my retirement account and now I have \$150,000, I'm going to figure I'll have to work a few years longer or be retiring less lavishly. People are trying to adjust to this loss and change their spending habits to account for it.

Isolated hail

Has so-called "corporate greed" played a role in creating this recession, or is it just a sexy topic for the media?

JJ People get outraged when they're struggling and they see a CEO making \$8 or \$10 million a year. But the CEO is the face of the company. The highest-paid employee at Auburn at any given point in time is probably our football coach, and in terms of the market, (his salary) is reasonable. When the day comes that 87,000 people will come and pay \$60 a ticket to watch me give a financial lecture, then I want to get paid what our football coach gets paid. You have to look at what they bring to the table. It's the CEO's job to make money for their company.

DG But it does touch a nerve when you see these guys go asking for taxpayer money at the same time they're getting multimillion-dollar salaries. And people wonder why they're asking for a bailout to handle a situation they've gotten themselves into.

A break in the clouds

Are there any signs that the financial crisis is turning around?

JH There are some positive things happening. If you look at the price of gas-

oline today, dropping from \$4 to about \$1.50 a gallon, we can figure that consumers will save \$250 billion a year just on gasoline—plus more on utility bills. That's a market stimulus. We could see \$500 billion savings from the cost of gasoline and crude oil if it stays at this level.

DG And it's a faster and more certain stimulus than waiting for our politicians to pass a tax cut. The only downside is that the reason gasoline prices are falling so much is there's a decline in the world demand for oil, and that decline is occur- The forecast ring because this is, in fact, looking like a global recession.

JJ Having the election over will help. A lot of the pundits felt that (U.S. president Barack) Obama clearly was favored, but until the election was over that threw in another element of uncertainty. Whether you like him or not, at least you know who it's going to be now.

Stormchaser

So, realistically, what can Barack Obama do to right the ship?

JH Given the economy, he'd better talk about reducing everybody's taxes. That's the stimulus program everybody needs right now.

JJ Including corporate taxes. We have the second-highest corporate tax rate of some zombies we're keeping alive, and all industrial countries in the world. And again, people always say, "let's tax that big company," but companies don't pay taxes—people pay taxes. Whatever (corporations) pay, the cost will ultimately be passed on to the consumers who buy their products or services.

BM Or if they have to cut costs in other ways it could mean jobs. So if we raise corporate taxes, eventually we pay the bill.

DG Class envy has won elections many, many times in this country. But Obama needs to remember the lessons of the Great Depression. (Herbert) Hoover helped turn a recession into a depression by increasing taxes to try and balance the budget, and by erecting trade barriers. But I think Obama is smart enough, and is surrounded by smart-enough advisers, to learn those lessons and not repeat that.

BM I'm pleased with the people he's surrounded himself with. He has made choices that bring experience to the table. But I'm still very concerned about the levels of intervention that could take place. We need to provide stimulus to the economy, but we need to make sure we are not

setting a slippery slope for the future that taxpayers are going to have to handle. We hear a lot about the automakers and their retirement and medical benefits, but the fact is that half of Americans do not have pension plans, very few of them are saving at the rate they need to for retirement, and many do not have medical insurance. We've got some other bills coming due down the road that are going to need to be addressed once we get past this recession.

How long will the storm last?

JJ I've heard anywhere from two years to five years or longer, but of course no one knows. I don't know that anyone expects it to last as long as the Great Depression, when it took 25 years for the stock market to recover—we have a lot of safeguards built in that we didn't have in

that time period. JH "Main Street" will get worse for a while; the financial markets will turn around first because they're based on future cash flows. But we don't want to be like Japan. Japan has been in a recession since the mid-'80s, and we gave them a lot of grief because they kept firms alive that should have been gone. There's some evidence in the United States that we have I'd hate for us to go down the same path Japan did. If we don't do all the same things and intervene too much, I don't think the recession will last longer than a

year or a year and a half. DG The seeds of recovery are already being planted, so hopefully by the end of 2009 we'll be back on the growth path. Some of the adjustments are already starting to bring about changes. Houses are being repriced, the stock market seems to have found the bottom, we've eliminated the uncertainty over the election, and we're seeing an unprecedented amount of cooperation between different countries to try and fix things.

JJ Generally speaking, recessions are bad but there is some advantage. Companies will fail, and we're seeing that now, but in the whole scheme of things sometimes it's good to purge the financial system of companies that are weak and inefficient. Data shows that as you come out of a recession you have more new businesses starting. A recession gives you a chance to purge weak, inefficient companies and start over. It's call creative destruction.