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Rekindling the Human Spirit in Business

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By the Economic Forecast Committee of the World Business Academy

EconForecast is a quarterly publication for the Members and Fellows of the World Business Academy. It presents a 12-month rolling economic forecast and a macroeconomic analysis of social and political conditions throughout the world.

The Economic Forecast Committee of the World Business Academy meets under the chairmanship of Academy Founder and President Rinaldo S. Brutoco to examine events and trends in the United States, Europe, Asia, Latin America, and Africa. The Committee includes economists, business executives, academics, and other individuals who collaborate to create this report by consensus. This issue was derived from a meeting that took place March 11, 2008. Given the rapidity with which the crisis in financial markets is unfolding, as well as the uncertainty about the future direction of U.S. economic policy due to the upcoming U.S. presidential election, we decided it would be prudent to provide more in-depth coverage of recent events and to shorten the time frame for several of our forecasts.

This spring the Academy will release a paper describing the innovative fiscal reforms necessary to dramatically improve the American economy. Such reforms will require redirecting military spending into the domestic economy. We urge our readers to watch for announcements about the paper's release.

Overview

The pervasive market uncertainty about the value of financial assets, particularly mortgage-linked investments, has led to a growing crisis of confidence within the U.S. financial system that the Fed's rate cuts and cash infusions have been powerless to cure. Unless the United States ends its over-reliance on monetary policy, and adopts a dramatically improved fiscal policy that is carefully balanced with its monetary policy, we see escalating stagflation and growing infection of global financial markets, with potentially catastrophic consequences. Increased infection would be likely to cause a much more severe economic crisis, including major distortions in domestic and international credit markets, a continuing collapse of the U.S. housing sector, a significant further deterioration in the U.S. dollar, rising inflation, escalating U.S. unemployment, and declining consumer and investor confidence. And that's just the beginning. Given enough turmoil in international capital markets, we believe that a global economic reversal of historic proportions could ensue.

The contagion from U.S. mortgage-linked investments has spread across the globe, but central bankers outside the United States, including the European Community Bank and the Bank of England, have done a better job resisting interest rate cuts and other inflationary policies.

Assuming we can avoid a serious dislocation in the international financial markets, a not altogether certain outcome, we believe that the deteriorating U.S. economy will slow growth in the global economy, but not enough to tip it into a recession. Several trends will help decouple the U.S. and global economies and reduce the impact of declining U.S. imports. These include European investment in clean technologies; strong growth in emerging economies; and new trading patterns such as Europe-China/Asia, China-Africa, Latin America-Europe, Latin America-China/Asia, and Eastern Europe-EC. Soaring oil prices, partly attributable to the devalued U.S. dollar in which oil is primarily priced, will continue to drag down global economic growth and benefit authoritarian regimes in Iran, Venezuela, Russia, and Sudan. Commodity prices have risen near an all-time high. They will stay high or go even higher in the next twelve months due to continuing strong demand by emerging economies, primarily China and India, for copper, food, iron ore, and other raw materials needed for their domestic infrastructure projects and rising standards of living.

United States

The evidence of stagnation is unmistakable and pervasive. The economy is experiencing a simultaneous economic slow-down and an inflationary spiral fed by the Fed's monetary policy and dramatically rising prices for food, fuel, and commodities.

The Fed is exacerbating the problems in the U.S. financial system by incessantly pumping in liquidity as if the problem with the frozen credit markets were the cost of money, rather than financial firms' lack of confidence in the value of financial assets. The Fed's repeated rate cuts and cash infusions create the likelihood of an acceleration in the inflationary spiral and a further rout of the dollar. Its actions also raise the question how much risk it can absorb if, as we predict, credits continue their escalating deterioration. The Fed has committed about 60% of its own reserves, which consist of less than $800 billion in cash and Treasury bonds.

Moral hazard: the danger that shielding people from the brunt of their decisions will encourage them to keep taking unreasonable risks.

On March 11, the Fed announced it would inject about $200 billion into the banking system by giving commercial and investment banks 28-day loans of Treasuries in exchange for mortgage-backed securities as collateral. Earlier in the month it had announced a $100 billion 28-day loan program. Since the March 11, 2008 meeting of the EconForecast committee from which this report was derived, the Fed expanded those loan programs; cut rates again;[1] orchestrated and financed the fire sale of Bear Stearns to JPMorgan Chase, assuming the risk of $29 billion of Bears' riskiest assets in exchange for dicey mortgage-backed securities as collateral.

"The rescue was absolutely all about counterparty risk. If Bear went under, everyone's solvency was going to be thrown into question. There could have been a systemic run on counterparties in general. It was 100% related to credit default swaps."
— Meredith Whitney, Oppenheimer bank analyst

In effect, without statutory authority to do so, the Fed has begun seriously committing the public purse to try to stop the financial markets' unraveling.[2] The Fed's extraordinary measures may well have been warranted by the short term emergency it saw looming, especially in light of the absence of any other federal action. The Administration has been like Nero, fiddling while Rome burned. Nevertheless, we are concerned that the Fed's actions may make matters worse in the long run. No one doubts that if the Fed's own resources prove inadequate to meets its commitments, the Treasury Department (i.e., the American taxpayer) will have to step up to honor those commitments with "the full faith and credit" of the federal government. To fail to do so would be tantamount to letting the U.S. government become bankrupt.

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[1] On March 17, the Fed announced that for the first time since the Depression it would open its discount window to investment banks, and cut the discount rate to 3.25%. Two days later, the Fed cut the discount rate to 2.5% (its sixth cut since August 2007 when it cut the rate to 5.75%), and cut the Fed Funds rate to 2.25%.

[2] On March 24, JPMorgan quelled a revolt among Bear Stearns shareholders with a revised deal that quintupled its $2/share price but was still far from the $170/share price at which Bear stock was trading in January 2008 or its $80/share price just days before the March 16 deal. The deal is structured so that the borrower is a new limited liability company which will receive $30 billion in Bear assets such as mortgage-backed securities. The NY Fed will lend the $29 billion to the LLC, which will pass the funds along to JPMorgan. The LLC will also get a $1 billion loan from JP Morgan, and will liquidate Bear's assets to repay both loans. If there are any gains on the portfolio left after both loans are repaid, the NY Fed gets to keep them. This suggests that the Fed's $29 billion cash infusion is really an equity investment rather than a loan, and thus outside the scope of its authority to lend money under section 13-3 of the Federal Reserve Act. That section authorizes the Fed, in "unusual and exigent circumstances" to lend money to people and companies that cannot get it elsewhere.

Financial derivatives: Playing "hot potato" in the shadow banking system

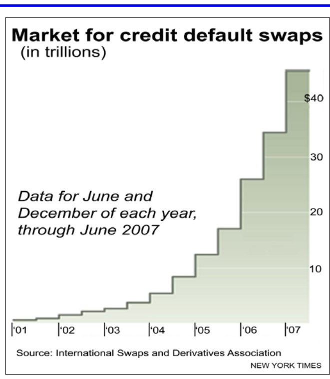
Former Fed Vice Chairman Alan S. Blinder suggested that mortgage originators and the investment banks that package and sell mortgages should be required to retain a chunk of their handiwork. "That way they don't simply play hot potato," he said.

"These are ordinary folks who know a spreadsheet, but they are not steeped in the sophistication of these kinds of models. You put a lot of equations in front of them with little Greek letters on their sides, and they won't know what they're looking at."
— Bryon Wien, chief investment strategist, Pequot Capital, discussing Wall Street managers' ability to assess credit ratings of new financial products

"If it is too complicated for most of us to understand in 10 to 15 minutes, then we probably shouldn't be doing it."
— Christopher Whalen, Managing Director, Institutional Risk Analytics

Financial derivatives are potential "weapons of mass destruction."
— Warren Buffet, Chairman, Berkshire Hathaway, 2003

Derivatives "enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it.…Regulatory risk measurement schemes are simpler and much less accurate than banks' risk measurement models."
— Former Fed Chairman Alan Greenspan, March 1999



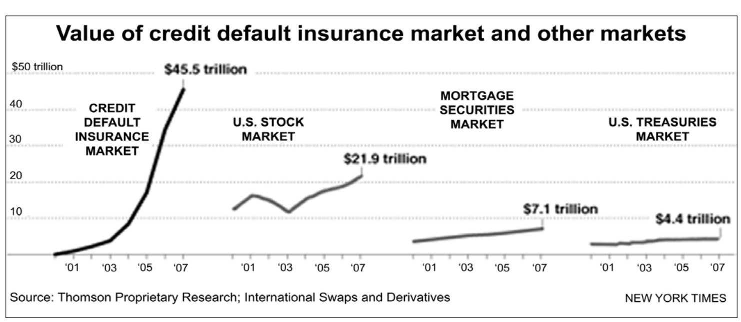
Without the means to judge asset quality and the adequacy of capital reserves—their own and their counterparties'—financial firms are reluctant to extend credit to each other at any price. Financial derivatives and other mortgage-linked instruments, often created and traded by "quants," now infect a host of bonds, CDOs (collateralized debt obligations), SIVs (specialized investment vehicles) and a host of other totally unregulated financial devices. Such devices have the ability to spread a balance sheet and cash flow virus throughout the global financial system with incredible speed and destructive force. The full consequences of this are possible to imagine but impossible, at this time, to predict.

Investors have shed the illusion that financial innovation can eliminate risk, but unable to find a way to assess risk, they are running from all risk and converting a liquidity crisis into a solvency crisis. As a result of the near-impossibility of valuing multi-layered securitized assets and assessing complex counterparty risk, investors are preemptively dumping hard-to-value assets, shunning even conservative investments, and holding on to capital that may be needed if a risk thought to have been unloaded suddenly reappears back on their books.

Earlier this year, the spreading subprime mortgage market crisis led to downgrades in bond insurers' credit ratings, as well as proposals to split the good and the bad in their portfolios to salvage affordable bond insurance for municipalities and other particularly credit-worthy borrowers. The crisis appeared to subside after bond insurers raised fresh capital but credit default swaps portend further upheaval in the bond insurance market, and on a much greater scale.

Credit default swaps: innovative insurance contracts to protect bondholders in case of a default

The fast-growing, unregulated market for credit default swaps totaled just $900 million in 2000 and now stands at $45 trillion, about twice the size of the entire U.S. stock market. Reportedly, JPMorgan Chase holds $7.8 trillion in credit default swaps, and Bear Stearns held $2.5 trillion in swaps in mid-March. It is difficult to value the swaps and financial firms' financial exposure to them partly because some of the insured bonds are based on subprime debt; to compound the uncertainty, the entities buying protection may not learn that the contract has been sold to a weaker entity until that entity becomes insolvent. According to PIMCO founder Bill Gross, defaults on credit default swaps could trigger up to $250 billion in additional losses on top of losses related to mortgage debt and that's if the crisis in the global financial system goes no further.

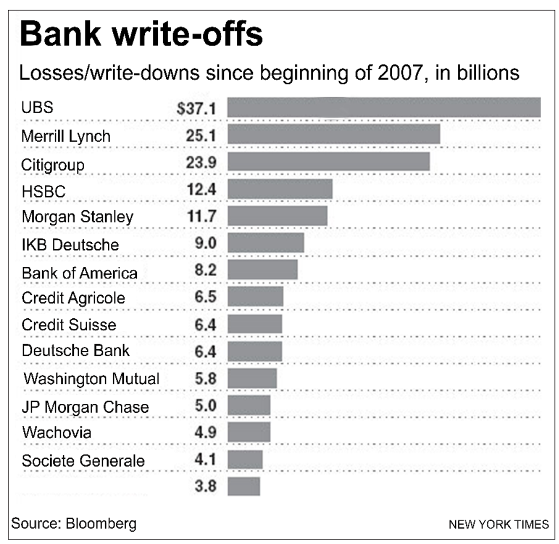


Investors' growing aversion to risk is engulfing Alt-A mortgage securities, a broad swath of mortgages long considered sound due to the creditworthiness of the "Alternative A" borrowers. In early March, as investors preemptively dumped Alt-A mortgage securities, the value of such securities that Thornburg Mortgage had posted as collateral fell, and it was unable to meet margin calls. Thornburg holds billions in securities backed by Alt-A mortgages. Its default may be the harbinger of further chaos in the $500 billion to $1 trillion Alt-A market. Like the collapse of Carlyle Capital after its failure to meet margin calls, the incident highlighted the speed with which excessively leveraged positions can collapse.

The spreading contagion is vividly highlighted by investors' refusal to hold auction rate securities, long thought to be as good as cash. More than 1000 failed auctions over three days in late February left municipalities and other creditworthy borrowers with double digit interest rates. The Port Authority of New York and New Jersey suddenly had to pay interest at a rate of 20% on $100 million of its debt, four times what it was paying a week earlier. Its weekly debt payments soared from $83,600 to $389,000.

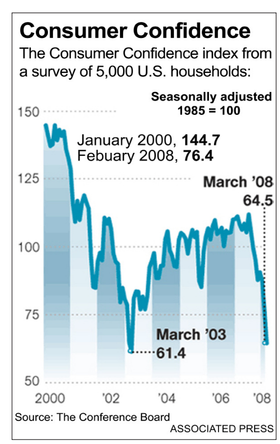
Auction rate securities: Long-term bonds that were considered as good as cash because investors could sell them at auctions that were held every few weeks. The auctions also re-set the bonds' interest rates.

Other losses could ripple through the financial system as a result of financial firms' large exposure to leveraged buy-out loans. A total of about $130 billion in such loans are held by just three firms—Goldman Sachs, Lehman Brothers, and Citigroup. There is also a continuing threat posed by the potential bankruptcies of companies owned by highly-leveraged private equity groups. For example, 34% of the companies in Blackstone's portfolio are impaired. Some hedge funds that specialize in asset-backed securities, such as bonds comprised of debt for private equity buyouts, have blocked investors' attempts to withdraw money in order to guard against a diminution of fund assets that might lead to margin calls.

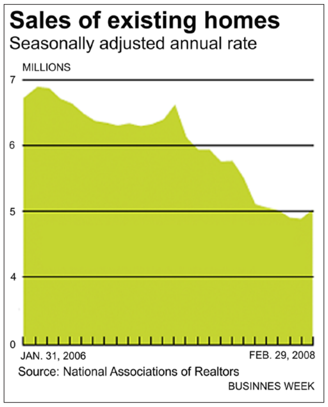


The amount of debt that banks and other financial firms have already written off is estimated to be in the hundreds of billions of dollars and on its way to a trillion. There is no end in sight, as we said in the last issue of EconForecast when the write-offs were in the $50-billion range.

The downturn is pulling in thousands of small and mid-size banks exposed to the softening commercial real estate market, and bank examiners have stepped up their audits. Local businesses that depend on those banks for financing will feel the squeeze.



We predict that economic conditions will continue to seriously deteriorate through all of 2008. Consumer spending is already slowing and will slow much more, propelled by shrinking housing wealth, rising fuel bills, a worsening job market, and mounting fear. Consumer confidence is approaching all-time lows, and is unlikely to improve during the next 12 months. In fact, it will worsen during the next several months, as the crisis builds until Congress finally faces down White House opposition and adopts the necessary fiscal measures such as the Frank-Dodds bill.

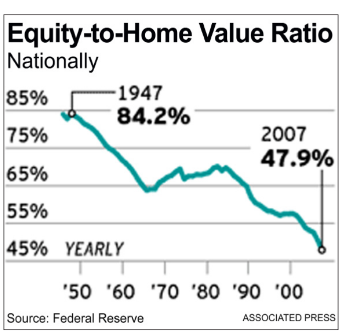


The housing market has not yet bottomed out, as evidenced by nationwide falling home prices, rising foreclosures, the large inventory of unsold homes, the downturn in new construction, continuing high mortgage costs, and the spreading lack of mortgage financing even for creditworthy borrowers. Permit applications for new home construction are at their lowest level since the early 1990s and are likely to continue falling in the months ahead.

The housing sector looks grim. For the last three months, the S&P/Case-Shiller home price index has shown prices falling across the country at an annual rate of more than 15%, with even sharper declines in some areas. The index showed a 9% year-over-year decrease in home prices through December 2007. In mid-March, Freddie Mac's CEO estimated that housing prices have dropped by only a third of what they will. Freddie Mac's chief economist, Frank Nothaft, speaking in late March, reported that sales of existing homes through the last three months of 2007 were down 29% from the same period two years earlier. He predicted that mortgage originations will drop 16% this year, and that this year's increase in foreclosures will surpass last year's increase.

We see the decline in home values accelerating in the upcoming quarter, affecting the weakest housing markets such as California, Florida, and Nevada, and sparking a serious decline in markets not yet hard hit, such as New York. It is hard to see how any area of the country will not be affected.

We predict that there will be more mortgage defaults and foreclosures later this year, even apart from the upcoming resets of adjustable rate mortgages (ARMs). The Mortgage Bankers Association reported in March that at the end of 2007, mortgage foreclosures were at their highest levels since it began tracking in 1979. It reported that in the fourth quarter of 2007, more than 2% of the nation's 46 million mortgage loans were in foreclosure and .83% of loans entered the process. An additional 5.82% of mortgage loans were delinquent in the fourth quarter, the highest rate since 1985, when the rate exceeded 6%. The combined 7.9% total percentage of all home loans that were delinquent or in foreclosure by December 2007 was up from 6.1% in December 2006. More than a quarter of subprime mortgage loans were past due or in foreclosure in the fourth quarter of 2007, and the number of prime, adjustable rate loans past due or in foreclosure rose to 8.1%, up from 4.3% in 2006.



Even more telling is that about 30% of all homes bought in 2005 and 2006 have mortgages that exceed their resale value. According to the Fed, aggregate U.S. home equity fell below 50% for the first time in history. It totaled only 47.9% in the fourth quarter of 2007, down from 80% in 1945.

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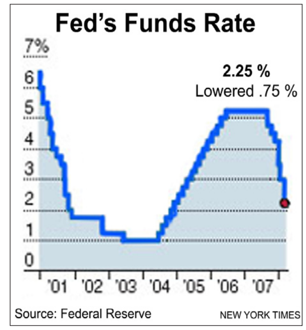
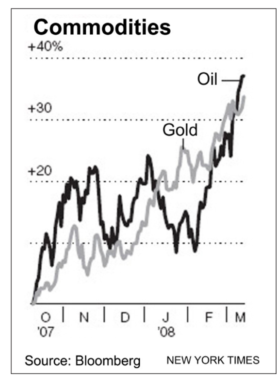
We are already well into "negative interest rates" due to the Fed's artificially low interest rates to shore up bank balance sheets and profits. Nevertheless, the Fed's rate cuts have not significantly reduced mortgage costs or made it easier for even good borrowers to get mortgages. We see a further freeze in the mortgage market until changes in fiscal policy relieve the Fed from having to fight this economic crisis alone.



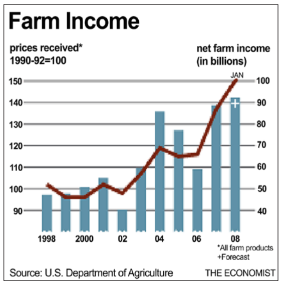
The Labor Department reported that the unemployment rate rose to 5.1% following a loss of 80,000 jobs in March, the biggest loss in five years. It also stated that January and February job losses were significantly higher than it had reported, and that a total of 323,000 jobs were lost in the first three months of this year. March was the fourth consecutive month that the private sector lost jobs, and the third consecutive month for the public sector. The Department's reported 5.1% unemployment rate is artificially low by several percentage points because for the last several years, the Administration has excluded from its unemployment count anyone whose unemployment benefits expired. The unemployment rate among those who are looking for work is estimated to actually be somewhere above 7%.

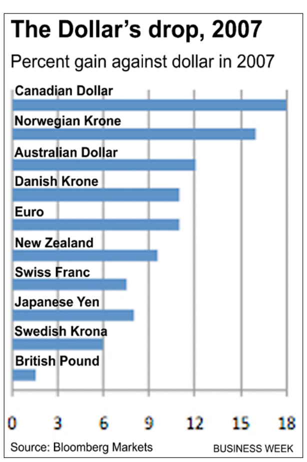


Inflation continues to rise sharply, fueled by oil prices above $100/barrel, soaring food prices, and the dramatic drop of the dollar, which automatically causes oil and commodity prices to rise. We will see more sharp increases in fuel, food, and raw materials in the near future. The Labor Department reported that January wholesale prices rose at an annualized rate of 7.4% and the January Consumer Price Index (CPI) was itself up 4.3% over a year earlier. We see wholesale prices in the United States continuing to rise for the foreseeable future and continuing increases in the year over year CPI.

Inflationary pressure is built into U.S. energy policy, which continues to subsidize fossil fuels at the expense of most renewables. Subsidies for the oil and gas industry curtail the United States' ability to free itself from its dependence on imported oil and from the inflationary impact of high oil prices. The House of Representatives has so far been unsuccessful in eliminating subsidies for the oil industry, including the 2004 domestic manufacturers' tax break, foreign tax credits, and the Clinton Administration's accidental royalty holidays for production in publicly-owned waters. These counterproductive subsidies, like those for nuclear energy, should be stripped away and the funds re-diverted to provide incentives for the development of safe, renewable energy.

As farmers have converted their farmland to corn to take advantage of excessive U.S. subsidies for corn ethanol, prices for corn, wheat, soy, and other feedstocks have soared, driving up the price of eggs, milk, and meat. Sharp increases in worldwide demand for grains and meat; several weather-related, poor wheat harvests; and poor land management have also driven world food prices up. During the last year, wheat prices more than tripled. Rising wheat and soybean prices are now prompting farmers to shift crops again.





The harm from corn ethanol subsidies goes beyond their inflationary pressure on all farm commodities. First, such subsidies worsen the problem of global warming. Most corn ethanol is produced with copious quantities of natural gas, in a process that consumes almost as much energy as it produces. Second, the subsidies constrain the United States' ability to rapidly make the switch from fossil fuels to renewable energy by creating a backlash against other, much more promising renewable energy technologies. Most of the subsidies go to the big growers which have emerged from the growing consolidation of the agricultural industry.

According to the Federal Reserve, over the past year the dollar has fallen 14.3% against a basket of trade-weighted currencies. Since 2000, the dollar has lost almost half of its value against the Euro, and it is at a 12-year low against the Yen. The dollar's fall will worsen if OPEC nations take former Fed Chairman Alan Greenspan's recent advice to stop pricing their oil in dollars. The modest rise in U.S. exports over the last year was far from enough to offset the downsides of the dollar's fall.

For a debtor nation like the U.S., there could be severe consequences from the dollar's decline and foreign investors' growing reluctance to hold dollar-denominated assets. The U.S. relies on a $2 billion a day influx of foreign capital to finance investment, but that influx is already slowing. Between 2006 and 2007, foreigners' net acquisition of long-term bonds and stocks reportedly fell from $722 billion to $596 billion. In the last six months of 2007, net purchases decreased 65% from the same period a year earlier. The more investors dump dollars, the more the Fed loses control over interest rates, making monetary policy even less effective.

It appears that the major purchasers of U.S. debt are foreign nations that correctly perceive that a precipitous decline in the dollar could trigger an international financial calamity; they therefore show up to buy as much as necessary to maintain an orderly market in U.S. Treasuries. It is impossible to predict how long foreign nations will be willing to do this in the face of U.S. policy that not only fails to strengthen the dollar but weakens it, ensuring that all dollar-denominated U.S. debt will fall in value in the foreseeable future.

Redressing the growing economic melt-down in the U.S. economy will require an artful combination of fiscal and monetary policy. The Administration's February 2007 economic stimulus package, consisting largely of modest taxpayer rebate checks ($300 for a single tax payer and $600 for a couple), is like throwing a pail of water on a five-alarm fire—the water will vaporize before it even has a chance to douse the flames. Many taxpayers' rebate checks will be absorbed by higher fuel prices, payments on credit card debt, or purchases of low-cost imported goods—none of which will infuse adequate new funds into the domestic economy. [3]

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3 To make matters worse, the poorest U.S. taxpayers will probably spend their money at Wal-Mart, which means that much of their money will go to China to pay for its manufactured goods. Fourteen cents of every U.S. retail dollar goes to Wal-Mart. The proportion of family income spent at Wal-Mart is even higher for families in the lowest economic strata.

Jumpstarting the housing market will take stronger action than the recent Fannie Mae and Freddie Mac reforms designed to address lenders' disinterest in making new mortgage loans that they cannot market. Earlier this year, Congress temporarily raised Fannie Mae's and Freddie Mac's conforming loan limits— the size of mortgages they can purchase — from $417,000 to $729,750 in over 220 expensive U.S. cities. The new limit also applies to Federal Housing Administration-backed loans in expensive housing markets. In early March, federal regulators lifted the caps on Fannie Mae's and Freddie Mac's portfolios, increasing the total amount of loans and securities they can own. [4]

In addition to the fiscal reforms to be proposed in the Academy's upcoming paper, the United States will also need to enact reforms to streamline the regulatory system and strengthen federal oversight of the financial sector and the myriad complex financial instruments it markets. Credit market reforms should, at a minimum, include: (1) improving the regulation and supervision of investment banks by, among other things, requiring them to disclose off-balance sheet risks, undergo adequate audits, increase their capital reserves, and improve their risk management practices; (2) improving loan origination and underwriting practices; (3) imposing tougher penalties on fraudulent lenders and brokers; (4) revitalizing the secondary mortgage market by enhancing federal agency authority to buy back or refinance distressed mortgages and enhancing incentives for private lenders to do the same; and (5) repealing the present limitation on bankruptcy courts' authority to modify debtors' home mortgages. Whatever the precise changes that emerge from competing proposals for reform of credit markets, we predict some regulatory consolidation to eliminate the present dispersal of responsibility among myriad federal and state agencies.

An emerging consensus

"Regulation needs to catch up with innovation . . . ."
— *Treasure Secretary Henry M. Paulson, Jr.*

"We have a terribly global world and, over all, financial regulation has not kept up with that. I can't even describe the seriousness of that. I always talk about how bad things can happen that you can't expect. I didn't fathom this event."
— *James Dimon, Chairman and CEO, JPMorgan Chase*

The mortgage debacle is probably the biggest mishap in bank supervision ever.
— *Henry Kaufman, President, Henry Kaufman & Company*

Canada

Canada's rich natural resources will barely enable it to maintain positive growth over the next nine months given Canada's historic dependence on the health of the U.S. economy. Soaring oil and wheat prices have increased Canada's export revenues, more than compensating for the reduction in its natural gas exports attributable to its unwise choice to use its natural gas to develop its tar sands. Producing oil from tar sands is an energy-intensive process that releases massive amounts of greenhouse gases and requires massive amounts of water. Effectively converting natural gas into oil makes no economic sense in the long-term.

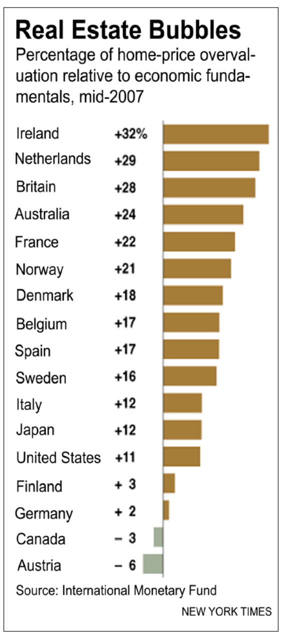
The biggest challenge for the Canadians in decoupling from the U.S. economy will be psychological—a challenge Canadians are likely to meet in light of the big boost the national psyche received from the record highs of the Canadian dollar against the U.S. dollar.

[4] Later in March, federal regulators reduced Fannie Mae's and Freddie Mac's excess capital requirements, which they had upped to 30% above statutory minimums after the discovery of accounting irregularities at Freddie several years ago. The higher capital requirement had effectively capped their respective loan portfolios at $746 billion.

Nevertheless, it is uncertain whether the Canadian economy will be able to withstand a downturn in exports to the United States. In addition to the downward pressure on exports from the relative strength of the Canadian dollar, Canada will face decreased U.S. demand for both natural resources and manufactured goods. The U.S. automobile industry will be purchasing consistently fewer Canadian autos, sub-assemblies, and parts as the U.S. slump in auto sales worsens in the months ahead. Canadian auto manufacturing already fell 16% in January and February 2007 over a year earlier. The manufacturing downturn will be partially offset by the strength of Canadian commodity sales, but U.S. demand for natural resources such as timber will weaken for the duration of the housing slump.

Europe

With a number of exceptions, most notably UBS, European banks have avoided the worst of the subprime crisis, but global financial institutions' profits have taken a big hit.[5] UBS already has taken a $37 billion write-down and still has exposure to over $30 billion in mortgage-linked securities.



Overall, economic growth in Europe is slowing. There are signs that the long boom in Ireland's economy may be nearing its end. Housing bubbles appear to be deflating in Spain and Britain, and other housing markets in the region are over-inflated. Based on trends in housing prices and mortgage debt in 17 countries, the International Monetary Fund's new World Economic Report concludes that home prices in a number of European countries are significantly higher than fundamentals would justify. Ireland topped the list at 32%, and also topped the IMF's list of countries in which mortgage debt has rapidly increased as a percentage of gross domestic product. On both lists, the Netherlands was not far behind and Britain was number three.

Real estate challenges in Britain could lead to a serious correction in its housing market. We predict that over the next six months, the British economy will not dip into a recession despite its evident weaknesses including the fall-out from the subprime mortgage crisis, its deflating real estate market, high levels of consumer debt, large welfare roles, and the disproportionately large share of its economic output that is attributable to the financial sector. Housing foreclosures are at their highest levels since 1999, and more than one million adjustable rate mortgages will reset significantly higher in the next 12 months. Britain's household debt-to-income ratio is 1.62, well above the German ratio of 1.09 and even higher than the U.S. ratio of 1.42. Looking beyond our six-month forecast above, it is quite possible that Britain will trend neutral to negative before March 31, 2009 unless the management of the U.S. economy significantly improves before the fourth quarter of this year.

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[5] Bank bail-outs can be particularly problematic in the EU because of its rules that require state aid to flailing enterprises to avoid undue distortions of competition. The European Commission has announced that it will investigate Germany's bail-outs of two banks and Britain's nationalization of Northern Rock.

Over the next 12 months, we predict real aggregate growth of about 1% to 1.5% in the Euro zone. European export industries face challenges from the higher Euro, which will probably remain in the $1.60 range or above. BMW has responded to the challenge with plans to move production to the United States, and other companies in the EU are moving production to Eastern Europe to cut labor costs.

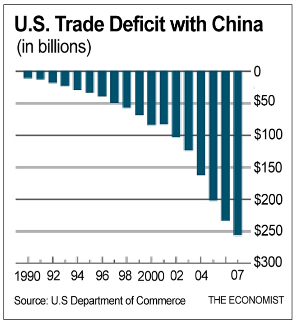
The slump in Italy, which is perennially unable to get its economic house in order, is caused as much by domestic politics as it is by macro global economic conditions. The Spanish economic boom has slowed, and the economy is now suffering from the falling housing market, rising unemployment, and the country's long-simmering but deep internal political divisions. There is unlikely to be strong economic growth in France, which is ambivalent about Sarkozy's proposed economic reforms, including the prospect of longer work weeks.

Even the pressure of Russia's ramped-up natural gas prices has not been enough to harm economic conditions in most of the EU, which continues to focus on improving its energy policies and reducing its oil consumption by developing clean alternative technologies and letting fuel prices rise much higher than in the U.S. With oil priced in dollars, the Euro's stronger purchasing power will help buffer the EU from upcoming oil price increases and the true cost of its oil dependence, even as the U.S. struggles with ever larger oil import bills.

Financial markets have become more cautious about Eastern European economies, even as they continue to grow and serve as a market for EU manufactured goods. Foreign investors have been especially put off by Hungary's high taxes, current account deficits, and an unpredictable business environment. Hungary's 1.3% growth rate is now the lowest in the EU.

Asia

Japan's economy will suffer more than others from the U.S. economic downturn, and its growth may dip into negative territory. It is heavily dependent on its exports to China, which largely consist of components for Chinese exports to the United States. Like other countries in the region, including Korea, which manufacture such components, Japan will be hurt by the reduced U.S. demand for imports. Its economy will also suffer from continuing governmental paralysis, the rising Yen, and flagging growth in the three million midsized companies that comprise about 70% of its economy. Since June, the Yen has risen 30% against the dollar. Toyota reports that every ¥1 appreciation against the dollar reduces its annual operating profit by $350 million even though Toyota is the best positioned Japanese car company due to its many U.S. factories. The strong growth rates of Thailand, Malaysia, and the Philippines, which expanded their economies through trade with the United States, are already slipping.



China's economy will continue to grow, probably at a slower and safer rate of about 6-8%. During the past year, pork prices rose 63% and vegetable prices rose 46%, but non-food prices rose only 1.6%. Continued high food prices could cause more civil unrest, but the increases to date have been partly attributable to problems in transport and the widespread disease at pig farms. Premier Wen Jiabao insists that China's rice stockpiles will protect it from the 30% jump in the price of rice on the world market. The government's efforts, partly prompted by the Beijing games, to clean up polluting industries, will slow growth, as will the shrinking U.S. export market. Overall, China's growing consumer market will continue to buoy the economy, as will heavy spending on infrastructure.

We predict a correction in India's overvalued stock market. The underlying economy remains strong despite endemic and severe corruption and the government's inability to develop the infrastructure necessary to support vibrant economic growth. The most promising growth has occurred in sectors that typically do not require many government approvals, such as the now deregulated air transportation sector. As these less corrupt sectors multiply and flourish, the cleaner economy will lead to demands for a cleaner political system. Despite problems, India's economy will continue to grow by at least 5-6% annually, supported by continuing growth in domestic demand.

Latin America

The Latin American economies are continuing to decouple from the U.S. economy, which will protect them from the U.S. economic downturn and help virtually the entire continent achieve positive growth rates for the next 12 months.

Brazil's economy continues to demonstrate the success of President Lula's "trickle up" fiscal and monetary policies which are integrating the poor into the economy. His dispatch of troops to the Amazon to stop illegal logging showed his confidence in his hold on power. Brazil's economy will continue its upward trajectory over the next 12 months, strengthened by the family-owned businesses that make up 38% of the economy. Its still-rising export earnings from oil, soy beans, and other crops will provide expansion capital for its current housing boom and help it become one of the strongest growth economies in the next 12 months. Its growing integration into the world economy should bring needed improvements in its protection of intellectual property.

Despite Venezuela's rising oil sales to China and India, Chávez is unlikely in the short term to carry out his threats to cut off oil exports to the United States, which still account for most of Venezuela's export earnings. Venezuela still needs U.S. refinery capacity to process its heavy crude. The threats followed ExxonMobil's successful suit to freeze Venezuelan assets after Chávez threw out contracts with foreign oil companies for development of the oil-rich Orinoco Basin and seized control of their operations. In another message to Uncle Sam, Chávez joined Ecuadorian President Correa in mobilizing troops along their borders with Columbia after the U.S.-backed Columbian government chased and killed a FARC rebel inside Ecuador. President Chávez continues to send a message that he is a force to be reckoned with, but his problems inside his country are mounting. The state-owned oil company PDVSA faces declining production, falling investment, and increased responsibility for funding all manner of government operations.

Argentina's commodities-based economy continues to do well. Panama is experiencing continuing strong growth, driven by canal and other infrastructure spending. Costa Rica's economy has somewhat slowed, and officials worry about the effect of a downturn in U.S. tourism. Inflation is above 10%, driven by high oil prices and the high cost of importing 100% of its wheat.

Among Latin American economies, Mexico's is the least decoupled from the U.S. economy. Falling remittances from its citizens working in the United States—historically Mexico's largest source of foreign exchange—will compound the problems created by falling production from the Cantarell oil field, historically the largest source of government revenue. The general economic stalemate has not been solved by American agricultural businesses moving to Mexico. The U.S. drug trade has contributed to destabilizing corruption at every level of Mexican society, including the police force.

Conclusion

The U.S. Congress, faced with an accelerating negative economic picture that a very concerned Fed is trying to address, could begin to force fiscal options to the fore. If that does not happen, the November presidential election may and should result in the creation of the carefully aligned fiscal and monetary policies necessary to stem the widening U.S. economic crisis. Until then, there will be a slow recognition that more liquidity and further interest rate reductions cannot in themselves solve the credit crisis. In fact, the Fed's rate cuts are already stimulating inflation, and further cuts will undoubtedly worsen it while failing to restore the domestic economy. More rate cuts will create an increasingly large chasm between the declining economy and increasing inflation. Stagflation will worsen until we alter our unsustainable fiscal and monetary policies.

Restoring order to U.S. credit markets will require sorting out who holds the losses now and deciding how to ultimately apportion losses among lenders, investors, and taxpayers. Solving the broader problems in the American economy will require systemic reforms, including new fiscal policies that the Academy's upcoming paper will explain.

Despite the crisis in the financial sector, investors can find long and short-term sound investments in renewable energy. Opportunities that can withstand an economic downturn include energy efficiency; geothermal; wind; solar, especially solar concentrators; ocean and river turbines; biofuels from algae; Corning Glass' new ceramic filters for capturing diesel soot; and "smart" utilities that install two-way, time-of-day pricing with meters that enable consumers to respond to price signals by adjusting energy use throughout the day.

The world economy is in transition from fossil fuels to renewables, and from a unipolar world to a multi-polar world. The reality of that transition is already buoying the global economy. The sooner that businesses and investors recognize this, the smoother and more profitable the transition will be. If only the U.S. Administration would start to act rather than fiddle, we could begin to contain the spreading contagion. Until then, the foreseeable future is much bleaker than almost all analysts are willing to publicly admit.

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