



# A US recovery imminent

Lessons from mistakes in the past have been forgotten, and hence, the world economy is once again passing through a similar depression to the 1930s. The only difference now is that the US government has acted faster and the policy prescriptions are on the right track. So, a right mixture of monetary and fiscal policy along with measures to reduce toxic assets can lead the economy to a quick path of recovery, says **Ilian Mihov**, professor of Economics at INSEAD.

It might not sound absurd and impractical that the US economy will start recovering more towards the middle of 2009 if we are to listen to Prof Ilian Mihov's, critical analysis of the policy measures taken by the Fed and his suggestions towards the road to recovery.

Though there might be a couple of bad months ahead and the evolution of the economy will depend very much on what policy-makers do, Mihov is of the opinion that "If there is an aggressive fiscal stimulus, if regulators deal with toxic assets promptly and if monetary policy continues to be expansionary, then the economy most likely will start recovering towards

the middle of this year." He further adds: "Since a good policy in the US is good for the entire world, as the US economy starts recovering, the emerging markets will be on track."

To establish his belief, he draws an analogy to the dynamics of the current global crisis in historical perspective. Over the past 130 years US income per capita (adjusted for inflation) has increased by an average of 1.85 per cent per year and as the evidence shows, apart from the Great Depression of 1929-1933, recessions are short and the US economy has so far always returned to the trend of 1.85 per cent growth in per capita income (Refer graph).

The US economy reverted back to a growth level of eight to 10 per cent after the Great Depression with four pronged policy intervention by Franklin Delano Roosevelt, the 32nd president of the US which recommended broad based fiscal expansion, change in the regulatory environment, reconstruction of the financial sector and allowing Fed to use monetary policy to increase liquidity aggressively.

## Cause of the crisis

The crisis originated from the bubble in the housing market and then other factors – like sub-prime lending, securitisation, leverage and opacity of the financial

instruments that magnified the problems resulting from the decline in housing prices. But Mihov is of the opinion that along with the above mentioned problems, the sophisticated signalling mechanism that was supposed to warn policy makers about any possible deep imbalances that are in the process of developing, have failed. Besides, low short term interest rates, regulatory inconsistency (while commercial banks were regulated and supervised closely, other investment banks and financial institutions were let loose), and lastly financial complexity and mispricing of risk added fuel to the fire.

Mihov feels the cause of the crisis to a great extent resembles to that of Great Depression in terms of shocks and amplification mechanism. "In general, it is correct to say that there are many resemblances between the Great Depression and the current crisis because both events have a very strong interaction between the collapse of the financial sector and the real economy. However, we are very far from the magnitude of the Great Depression when output losses were around -10 per cent per year. In the current crisis, this year output loss is expected to be around minus one per cent."

Despite the difference in magnitude, due to similar nature of the crisis, the policy measures, according to Mihov, should be in the same direction.

## Policy measures

Mihov feels that a lot has been done in monetary policy and policy makers have tried to rescue the financial sector.

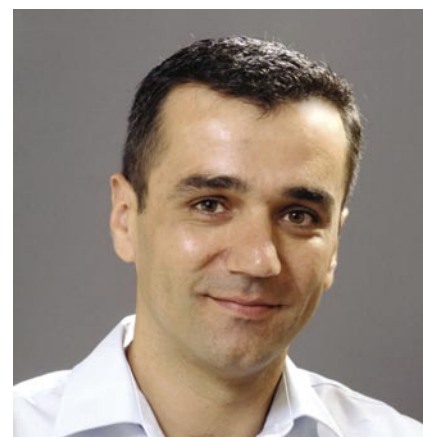
The Fed started with a rather standard response to the crisis by lowering interest rates in 2007-2008. The collapse of Lehman Brothers completely changed the game.

The massive injections of capital in the US and other advanced economies did not generate the necessary revitalisation of the lending process; hence, the Fed opened its lending window directly to non-financial institutions in the commercial paper market. This helped firms to pay suppliers and workers at a much lower rate than that from commercial banks.

However, lending of commercial papers is only one of the few lending facilities opened by Fed during the past 12 months. Measures like reductions in interest rates and intervention by the Fed in the credit market by providing credit directly to financial and non-financial institutions are expected to reduce substantially deflationary pressures.

Still, according to Mihov, two urgent components are missing from the policy measures taken so far. The government has to deal with toxic assets, and thus intervene in the financial sector. And also create a new regulatory framework that will have to address the asymmetry between the importance of investment banks in liquidity provision (through securitisation) and their status by and large as unregulated entities.

And secondly, there is no fiscal policy action yet which is usually done via changes in tax rates and government spending. By cutting taxes or increasing



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spending, the government can prop up demand in the economy and stop the vicious circle. "There is little doubt in my mind that a well-designed fiscal package can shorten the recession dramatically and make it much shallower than a recession without a fiscal stimulus. Unfortunately no major fiscal policy measures have been taken mainly due to the transition in the leadership," Mihov points out.

Whether too much injection can fuel inflation, Mihov feels that, in the current context, that possibility is ruled out as the liquidity created by the Fed is stored in the vaults of commercial banks as excess reserve and there is almost no increase in broader measures of money. Also if the Fed feels a threat of inflation, it can easily mop up excess liquidity either by closing down lending facilities or by increasing interest rates, according to him.

He also rules out the possibility of inflationary pressures due to increase in government debt as central banks in developed economies do not ordinarily finance deficits by printing money, rather the spending programs of governments are financed by issuing government securities, i.e. by borrowing.

Mihov stresses the need for aggressive intervention by the US government as he believes: "Without aggressive intervention the economy will go down into a vicious circle. A decisive action in early 2009 will help the economy avoid a bigger bailout in the future. After all, the current financial crisis has a levelling effect on global imbalances."

