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A new term, but an old remedy

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As Barack Obama is inaugurated as the next President of the United States on January 20, his first task is to "jump-start the economy."

Recession, which Obama has inherited from the Bush Administration, had its beginnings as early as December 2007, though officially recognized only in November 2008.

It is now deeply entrenched and acknowledged as the worst recession in seventy years, since the "Great Depression" of the 1930s.

As a result of recession, the US economy lost 2.6 million jobs in 2008.

The loss of jobs in December was more sensational. It was the worst job losses (524,000) since the end of the Second World War in 1945. The December unemployment figure was 7.2 percent, much above the target rate of 4 percent.

The American recession was due to the housing bubble, which burst in late 2007. Excessive lending was supported by credit institutions, recklessly pushing funds to all and sundry. The credit institutions neatly packaged these mortgaged loans into securities or assets, which were sold to overseas financial sector institutions, in Britain and Europe. The proceeds were used for yet another round of reckless lending.

Once there was an oversupply in housing market, house prices began to fall resulting in loan repayment defaults and the bubble eventually burst. Countries which were exposed to American debts became vulnerable.

Sub-prime loans

When financial institutions failed, the credit crunch spread. Credit flows became frozen and the real sector was soon affected. As credit could not flow, the economic giant had to grind slowly to a halt.

That signaled the fall in investment demand, as businesses were not getting funds from banks and losses of jobs ensued. Fall in incomes led to decrease in consumption. So the continuous fall in price of assets and general price level signified deflation.

It was a sustained fall in prices in 2008, and decline in manufacturing activities, affecting demand for overseas goods. The emerging economies such as China which built huge trade surplus over the decade have now been seriously hurt, as its exports to US and industrial world fell.

The worldwide recession is now authoritatively traced to poor functioning or (poor regulation by authorities?) of the credit institutions.

In 2008, the American media has thus added a new term to economic lexicon: sub-prime loans.

It is a euphemism for non-recoverable, outright bad loans: loans for projects poorly appraised and sanctioned to persons with poor credit history.

Quantitative Easing

In 2009, one other new term will be gaining currency: “quantitative easing.”
Soon every one will be using it, to describe the present pump priming policies of central banks all over the industrial world.

As part of fighting the recession, the American central bank (the Federal Reserve, known as the Fed) has been implementing a cheap money policy. Its current bench market interest rate, known as the Federal funds rate is zero to 0.25%. Following the US lead, the European Central Bank reduced the rate for its 16 member countries to 2 percent, which is the lowest since December 2005. The current UK rate is 1.25 percent.

Banks have plenty of liquidity, as the central banks are adding to the reserves through open market operations.

As they are not sure of asset prices in a deflationary world, banks are keeping all funds as excess reserves.

They do not trust any one.

So there is no scarcity of liquidity, but only a famine of confidence.

Helicopter drop

Ben Bernanke, the chairman of the Board of Governors of the US central bank, then a governor, in a speech in 2002 was referring to deflation fears in Japan. But he confidently asserted that the “the chance of significant deflation in the US in the foreseeable future is extremely small.” He pointed to “the strength of our financial system: despite the adverse shocks of the past year, our banking system remains healthy and well-regulated, and firm and household balance sheets are for the most part in good shape.” He also mentioned that the government owns the physical means of creating money, indicating the government can always avoid deflation by simply issuing more money.

Most economists believed that preventing another Great Depression would be easy. They included Nobel Laureate Robert Lucas of the University of Chicago who in his presidential address to the American Economic Association, declared that the "central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades."

Another Nobel Laureate Milton Friedman argued that the last Great Depression was due to failure of the central bank to provide liquidity which led to failure of the banks. So the persuasive influence of Friedman has been so strong that central bankers believed that increase in money supply would prevent deflation.

With the observed reluctance on the part of reluctance to lend, the question before the central banks is how to transfer cash directly to the household sector.

“Helicopter Ben” is just doing it: providing more liquidity to the banks. But the economy is caught in a liquidity trap. It is not moving.

In such circumstances, monetary policy and fiscal policy collapse into one.

A new term for printing money

Since the benchmark interest rate is zero, there is no scope for any more cut in interest rate. The only way out is printing money: the new term is quantitative easing. That is increasing quantity of money by open market operations. Fiscal deficits come handy and they remain the only solution.

It is expected the US legislature would approve an US $825 billion stimulus package. With the past bail outs, the fiscal deficit will go beyond on trillion American dollars.

After President Obama signs the bill, the government will float bonds, which will be the safest asset for all savers/investors, households and institutions to buy. Following the bond issues, the Fed would conduct open market purchase of bonds and put the funds back into the hands of the public.

That is the quantitative easing now visualized.

When the interest rate is zero, it is the only thing the Fed can do.

What President Mugabe was doing in Zimbabwe, was printing and adding to money supply in a shortage-ridden, inflationary economy.

Now, what the Fed would be doing, is an attempt to fight recession by increasing money supply in a deflationary economy.

However, the Fed has to be watchful and mop up the excess money in right time, once inflationary pressures are detected.

That will be another challenge!

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