

---

# US economy recovery 'likely' by year-end



**Although the current global economic gloom continues to cause sleepless nights for many CEOs, it's a “likely scenario” that the US economy could start to recover from its recession by the end of this year, says Ilian Mihov, INSEAD professor of economics.**

What warrants the optimism? For starters, two major economic imbalances in the US - the ratio of house prices to income per capita and domestic consumption to income ratio - could be unwound by year-end, as over-inflated house prices fall and debt-fuelled spending declines amid the economic shakeout.

“In other words ... the foundations for recovery would have been set,” says Mihov, a former doctoral student of Federal Reserve chairman Ben Bernanke. Mihov shares the Fed chairman’s optimism of the start of a recovery by year-end although he has concerns that the US administration may not be moving quickly enough to tackle the banking crisis.

Mihov was speaking to INSEAD Knowledge ahead of US Treasury Secretary Tim Geithner’s unveiling of three federal programmes to clear toxic assets from the balance sheets of banks. Under the three-part 'Public-Private

Investment Programme', the government will offer private investors immense amounts of cheap public financing to match every dollar of private investors' capital.

Under such an ambitious partnership between the government and private investors, as much as US\$2 trillion in real estate assets - which have been instrumental in causing the financial crisis - could reportedly be acquired. This could then unfreeze the credit markets and lead to the normal resumption of lending activities by banks, paving the way for an economic recovery.

On the government's earlier US\$787 billion stimulus package, which was passed by Congress in February, Mihov says the move was "in the right direction" even if efforts to rid the toxic assets from the balance sheets of banks have been progressing slower than some were expecting.

In handling the financial and economic crisis, the record of the first hundred days of the Obama administration is mixed, Mihov says.

"I would say they (the Obama administration) are moving too slowly, possibly from an idealistic point of view. You know the right actions are .. and you want to implement them right away."

"But of course the political process and the technical details of these programmes are so complicated that it's not possible to do it faster than this. I'm not sure that anyone else could have done it faster."

In recent weeks, President Obama and Treasury Secretary Tim Geithner have come under fire from US lawmakers and Wall Street for being slow in coming up with a detailed plan to acquire toxic assets from banks to resolve the banking crisis.

But in addressing the present economic downturn, current US fiscal policies are "more aggressive" than those implemented in the Great Depression in the 1930s, while the Federal Reserve has adopted a highly expansionary monetary policy in providing liquidity to banks, Mihov says.

Still, Mihov believes that the key to kick-start economic growth by resuscitating the banks lies in the adoption of the so-called Swedish model of the 1990s, whereby a "bad bank" is created by the government to clean up the balance sheets of banks by acquiring their toxic assets.

Indeed, it is crucial to resolve the toxic assets, such as mortgage-backed securities, as they are a “cancer” on the balance sheets of banks.

“If the financial sector doesn’t work then the economy is not going to recover,” Mihov told INSEAD Knowledge.

He explains that the magnitude of the present financial turmoil was caused in part by the willingness of the US government to allow the collapse of investment bank Lehman Brothers, which was laden with toxic mortgage-backed assets. This caused banks to stop lending because of widespread uncertainties about the financial integrity of the financial sector and fears about the withdrawal of funds by spooked investors, which could lead to further bank failures.

“If we remove the toxic assets, then banks will have a big chunk of their uncertainty removed and this would eventually lead to resumption of lending.”

So if a “bad bank” is created by the end of April or early May, all the conditions for an economic recovery would be in place by the summer or in early fall, Mihov adds.

But banks are reluctant to dispose of their toxic assets in a falling market because values will continue to plummet. Already, some mortgage-backed securities are reportedly trading at around 40 cents on the dollar, and this is driving fierce public debate about how toxic assets should be priced.

However, Mihov argues the debate is a “non-issue”. He says the “bad bank” could buy toxic assets based on their current market values. To entice banks to offload their toxic assets, the “bad bank” could promise to return any profits arising from the toxic assets when they reach maturity.

But if the “bad bank” incurs losses from holding the toxic assets to maturity, then it could perhaps receive equity in the banks equal to the amount of the losses. The value of the equity should be based on the market value at the time of the purchase agreement.

So although US taxpayers will likely foot a trillion-dollar bill for the acquisition of toxic assets by the “bad bank”, the downside for taxpayers in the long term would be limited.

“At the end of the day, in both cases (profits and losses), taxpayers may gain because if these banks indeed survive 10 years from today, you might be able to get stock in Citibank for US\$2.50 (compared to) when Citibank might

be US\$10.50 or even US\$50 at that time (in the future),” Mihov says.

[http://executive.education.insead.edu/strategic\\_banking](http://executive.education.insead.edu/strategic_banking)

Strategic Management in Banking

[http://executive.education.insead.edu/banking\\_risk](http://executive.education.insead.edu/banking_risk)

Risk Management in banking

**Find article at**

<https://knowledge.insead.edu/economics-finance/us-economy-recovery-likely-year-end>