
Obama could help US economy recover by mid-2009



The victory of Barack Obama, the first African-American to become president of the United States, could help the troubled US economy recover by the middle of next year, says Ilian Mihov, professor of economics at INSEAD.

“Obama’s platform when he was campaigning was to increase government spending and cut taxes. If the change is aggressive and very determined, I think the US economy can start recovering by the middle of next year,” Mihov says.

With the US economy being dragged into recession and economic conditions expected to deteriorate further this quarter, the Federal Reserve aggressively cut its key rate to 1.0 per cent from 1.5 per cent at its rate-setting meeting earlier this month.

Mihov believes the Federal Reserve has not necessarily exhausted all the tools needed to stimulate the economy with the recent aggressive rate cut. “Lowering interest rates is necessary but this does not exhaust all the tools available to the Fed in order to stop deteriorating demand.”

Should economic conditions deteriorate further in the months ahead, the Fed will likely ease rates further to near zero, much like what Japan has done in recent years. But the Fed's strategic options do not end when key US interest rates fall to zero or near zero.

The Fed can inject liquidity into the financial system by other means other than cutting interest rates, Mihov says. The Fed has been providing liquidity to banks, causing the Fed's balance sheet to more than double to US\$2 trillion from US\$890 billion, he says.

But because banks have refused to lend due to the prevailing uncertainty, monetary aggregates in the US are shrinking , prompting the Fed to become the lender of last resort to companies in need.

"The Fed has made unorthodox changes," Mihov says.

Among the key changes the Fed introduced under the leadership of Ben Bernanke is the purchase of commercial paper from companies which cannot get access to normal credit channels.

"This is unprecedented. At the same time, this is a way of minimising the impact of the credit crunch," Mihov says, noting that the credit extended by the Fed to cash-strapped companies ballooned to US\$240-250 billion within a period of just 10 days.

More work needs to be done to stimulate the economy and counter deflation.



“It remains to be seen whether the US Congress will immediately approve an aggressive fiscal stimulus. As we saw in the case of the US\$700 billion bailout package discussions, sometimes politicians do deviate in the wrong direction instead of being focused on the fact that the faster you do this, the smaller will the damage be,” Mihov says.

It took Congress several weeks in September and October to pass the bailout plan even as bank failures in the US mounted, with Lehman Brothers going bankrupt and mortgage giants Freddie Mac and Fannie Mae being nationalised.

The handover of power from George W. Bush to Obama is now crucial.

“Transitions are a very serious issue. If you look at 1932-1933, Roosevelt was elected in November 1932 but somehow he stepped into the White House only in March 1933,” Mihov says.

“The biggest banking panic in the US occurred in January 1933 during the transition when the outgoing president did not have much an incentive to do anything and when the incoming president did not have the power to do much,” he says.

Should the politicians acknowledge the severity of the economic problems and realise that the longer they wait the bigger the problems could become, Mihov says it is possible to start discussing possible solutions and move ahead.

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