US back on growth path within four years

(Translated from Dutch)

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The chances of a W-shaped recession are low. Indeed, within four years, the U.S. economy should return to the pre-crisis growth path, expects Insead economist Ilian Mihov. The originally Bulgarian economist Ilian Mihov is now a much sought after guest on U.S. and U.K. television channels such as CNBC and BBC. But according to him, it is not so much due to his own person. "Because people know that I've studied under Bernanke and have published a number of scientific articles with him, they think that I can tell them what the Fed chairman is planning", he laughs.

Just like Ben Bernanke, Mihov – who in recent days has been teaching the course "Macro-economics and Global Financial Markets" at the Amsterdam Institute of Finance – has been delving into the causes and aftermath of the Great Depression. We have learnt from the Great Depression, and have applied the right lessons to address the current crisis, he says.

How do you see the current economic crisis further developing? "A whole alphabet of scenarios has now passed the review: U-, V-, W- or L-shaped recovery. As regards to the latter, I've never seen an L-shaped recession. People think of the Japanese banking crisis, but that lasted so long precisely because Tokyo took so long to intervene. There was appropriate policy response only in 2002, while the crisis started in 1989/1990. In the current crisis, policymakers have responded very quickly and aggressively.

History also indicates that slow economic recovery is due to incorrect or inadequate policies. The Great Depression is an example of this: an adequate response came only under Roosevelt.

The current projections of major forecasting agencies, including those from the International Monetary Fund, also seem to indicate that the rapid actions of policymakers in the current crisis have been effective. I clearly see a V-shaped recovery in growth."

But then from a lower base? Some say that the world economy will never catch up with the damage. "On the contrary. The data gives you a very different picture. For example if you make an analysis of the U.S. GDP per capita, you see over the period 1870 to 2006 a relatively steady growth of 1.85% per year.

Of course there are exceptions: the Great Depression of the 30s, the Second World War, the oil price shocks of the '70s, the dotcom bubble and so on. What you see is that the economy deviates but eventually the growth returns to the underlying trend. That trend reflects our basic ability to produce and is driven by knowledge and new ideas. We see a relatively constant series of major and minor innovations that maintain growth. Conversely, it seems like we are not able to transcend the basic trend permanently – temporary acceleration happened during the Second World War and the internet bubble, but then we returned back to the old growth path. Where it should be further noted that other industrialized countries have a tendency to converge at the U.S. pace."

So the U.S. economy will fully recover? "Currently the United States is about 6% below trend. I expect the economy in 2013 to be back at the old level. That means catching up with about 3% to 4% growth in the coming years. I am relatively optimistic; I see a strong V-shaped recovery."

Yet there are fears of a "double dip" - a W-shaped recession. "Historically, a W-shaped recession has always come from policy change of direction. For example, when the former Fed Chairman Paul Volcker raised interest rates in 1979 and the economy entered into a recession, then in 1980 the Fed lowered rates and later in the year reversed its policy stance again by raising interest rates to almost 19%.

I do not see such a sharp turn in policy. The economic stimulus package that was implemented in September needs still largely to be spent. If we continue on this path, and make no silly decisions in fiscal policy, then there is no need for a second stimulus package and there will be no second dip.

We can get a W recession if there is another shock that we do not expect at this point or if inflation unexpectedly rises. Should inflation come above 4.5%, then the central banks will raise the interest rate and you really face the danger of a W recession.

But given that a banking crisis usually brings a huge production backlog, it is unlikely that major inflationary pressures will arise in the short term.

To what extent will China compensate for the decrease in American consumption? "The American consumption will continue to grow, but at a slower pace. Of course it is true that consumption levels in China are far below that of the U.S., but if the Chinese economy continues to grow at 10% and consumption continues to keep pace with that growth, then the decline in U.S. consumption will be at least partially compensated. And then you also have countries like India and Indonesia.

The most pessimistic scenarios are focused on the debt of American households but often ignore one important fact: against those debts, there are also assets. The debt ratio of 100% of GDP is shocking, but the net asset position of households is still 375% of GDP, i.e. above historical averages. The debt financing costs have increased, but they are not unsustainable. Currently, the ratio of financial obligations to disposable income (i.e. how much of your after-tax income you have to set aside to repay loans, credit cards ,property taxes, etc.) is approximately 18.1%, while the average from 1980 until 2009 was at around 17.2%. These are difficult times, but the current figures are not very different from historical averages."

What reforms do you need? "I think we will see major changes in policy. The Great Depression ‘created’ fiscal policy and monetary policy as stabilization tools. Monetary policy was abused in the 1970s during the Great Inflation but then the 80's saw the rebirth of monetary policy. Now it is important to establish a policy that controls systemic risk in financial markets. And that should be a dynamic monitoring process. It is no longer sufficient to have static ratios. We need to have a policy body which constantly keeps up with innovations and their associated systemic risks in the financial markets. This body will be organized along national lines, not supranational. The G-20 and the Financial Stability Board may have some coordinating role to play, the IMF may provide the basis for cross-country comparisons and analysis, but it is very unlikely that any of these bodies will act themselves as regulators or supervisors."