

Prospects of us Recovery after the Near-Zero Policy Rate

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After the US Federal Reserve Bank (Fed) has announced a series of aggressive policy rate reductions to cope with the severity of the US financial crisis from 5.25 per cent in September 2007 to a range of 0 to 0.25 per cent, the lowest levels in history, on December 16, 2008, the whole world anxiously awaits the US economy coming out of this year-long recession. Questions now centre on the effectiveness of monetary policy easing and that of the numerous unconventional measures created to alleviate tensions in the financial markets, which included pumping in liquidity into financial markets, rescuing troubled financial institutions, and purchasing long term treasury bonds to help lower long-term interest rates.

Thus far, the aforementioned policy efforts have lessened the severity of the financial market problems to a degree. The indicator showing liquidity conditions such as the 3-month LIBOR Spreads to Overnight Index Swap has significantly improved although remaining higher than during the normal period. However, the crucial problem remains the elevated credit risks.

Meanwhile, the real sector has not yet benefited from the above policies. It will take more time for monetary policy easing to yield results owing to its limitations during the period of heightened economic and financial risks. The latest economic numbers, which include consumer and business confidence, production and sales, have continued sharply deteriorating trends. In fact, the most crucial indicator that has been quickly worsening is employment, which in turn means that domestic consumption will not improve anytime soon. As for the housing sector, the centre of this crisis episode, house prices and home sales have also continued to decline.

When will this recession be over? Some economists such as those at the Federal Reserve Bank of San Francisco have predicted that the US economy will recuperate in the second half of 2009. A similar view comes from Consensus Economics Inc who has compiled projections from various forecasters. The overall assessment indicates that the recovery will be slow and the economy will still expand below the potential pace as the damages in the financial sector abound and have wide-range ramifications on the overall economy.

It is a wild guess to pinpoint the timing as the recovery will take time and depend on several factors. They include the improvement of monetary policy effectiveness and the effects of the expected fiscal stimulus package with both government spending and tax cuts on building up the momentum of economic recovery.

Going forward, we need to watch out for certain positive signs that would help indicate that the US economy has already bottomed out. Specifically, improving consumer and business confidence will be one initial indication. Stabilisation of house prices is also another essential indicator as it will help reduce the burden of financial institutions with losses from investment in mortgage-backed securities, enabling them to lend more to spur the economy. Having said all this, we can breathe a sigh of relief only when consumption recovery takes hold and the US purchasing power gathers strength.

Let's hope that it will happen sooner rather than later

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