Third Bisalaiah Endowment Lecture Delivered by Prof. Kishore G. Kulkarni*, Metropolitan State College of Denver, Denver, Colorado, USA on December 15, 2009 at the Rani Bahadur Auditorium, University of Mysore Campus, Mysore, India.

First of all, my big "thank you" to the wonderful faculty of the Department of Economics, University of Mysore, especially to Drs. Hosamane and Sriramappa, who invited me to deliver this lecture. My special thanks are also to Dr. Talawar the Vice Chancellor, University of Mysore and Dr. Bisalaiah, an eminent scholar of monetary economics himself, whose kind and generous heart has established this endowment that made my coming here possible.

Visiting Karnataka State is not a new thing for me as in my first visit, I was a part of a winning Kho-Kho team from Pune that came to the town of Shimoga, back in 1973 to play the All India Kho-Kho championships. I vividly remember, in that visit, we picked up some Kannada words such as Vandu-yardu-moru-narku, yantu wambattu and hattu. We were also used to saying "Neer kudu", "roti kudu", "beer-kudu" and other important things. Joke apart, it is my great pleasure to be here again, to be in front of you to deliver this lecture on the topic of "Economic Mess in USA: Where Did It Come From and Where Is It Headed?"

For the benefit of those who are hungry for food and want to leave early, let me answer the last part first. To sum up my answer in four words I would like to say: "I do not know". This is because, economic forecasting is not only a dangerous business but is also quite adventurous and shameless especially when you are wrong numerous times. Then again, I find many of my economist colleagues who come up with the exact shapes of the US economic recovery. They even give economic recoveries some funny and exotic shapes such as U shaped recovery, V shaped recovery, W shaped recovery etc. To be honest with you, all my economic training (and thinking) tells me that I have no idea where these experts get these shapes from, and how they become so confident about the future. It is in fact wrong to be so confident about the future which strongly depends upon future unknown shocks, but that does not stop many of us. Economic and financial forecasting are the only fields in which you can be consistently wrong and still call yourself an expert!!

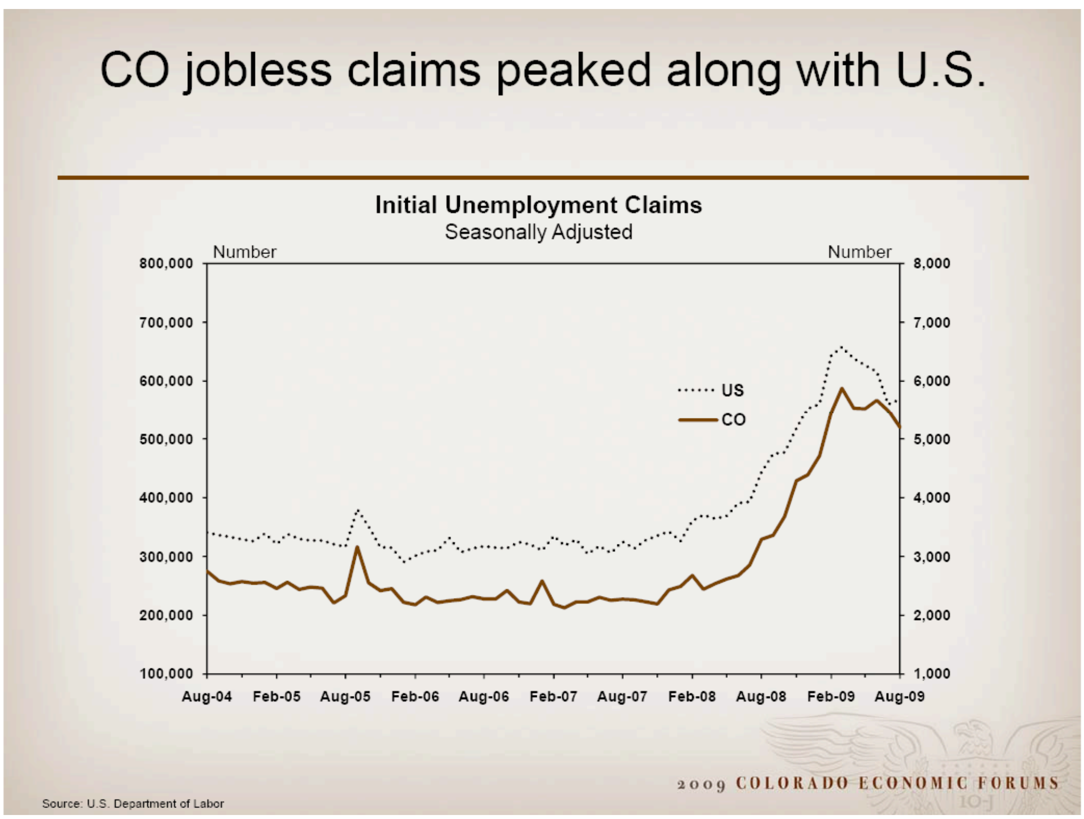
In essence, if 50 economists make 50 different forecasts, one gets to be true and then he/she becomes a millionaire. However, there are at least two cases of even millionaires being totally wrong or confused about the future. One case in point is the recent interview of the longest lasting Federal Reserve Board Chairman, Allan Greenspan who confessed that whole economic mess of the US economy, "hit us like a tsunami". Now this admission is from a Chairman whose job was clearly to forecast at least with some certainty the future economic events!!

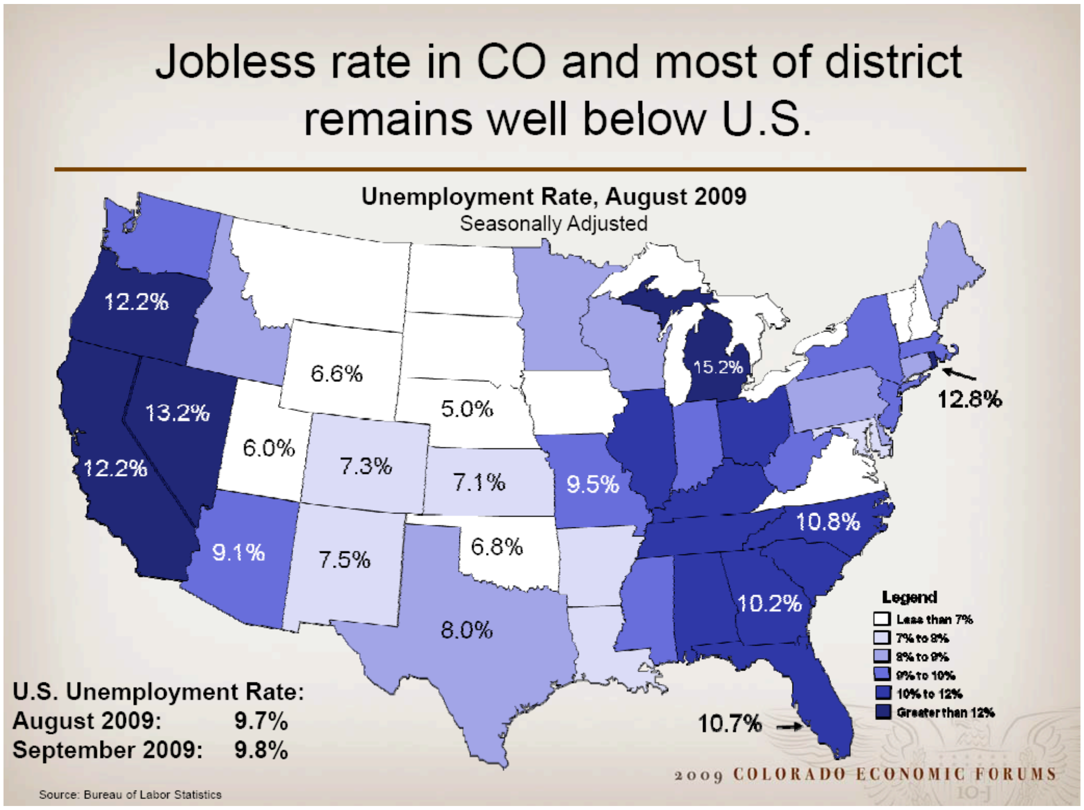
My second case is even more interesting, and is the one I observed quite closely when my friend, Dr. Ravindra Batra of the Southern Methodist University of Dallas, Texas, wrote a book in 1985 to predict the Great Depression of 1990s. In his book Prof. Batra not only had a forecast of the Great Depression for 1990s in USA and in the whole world, but also had some explanations of how to get out of it. There are 3 chapters of the book in which he explains the way a family of four would survive this Great Depression when it was supposed to hit in 1990s.

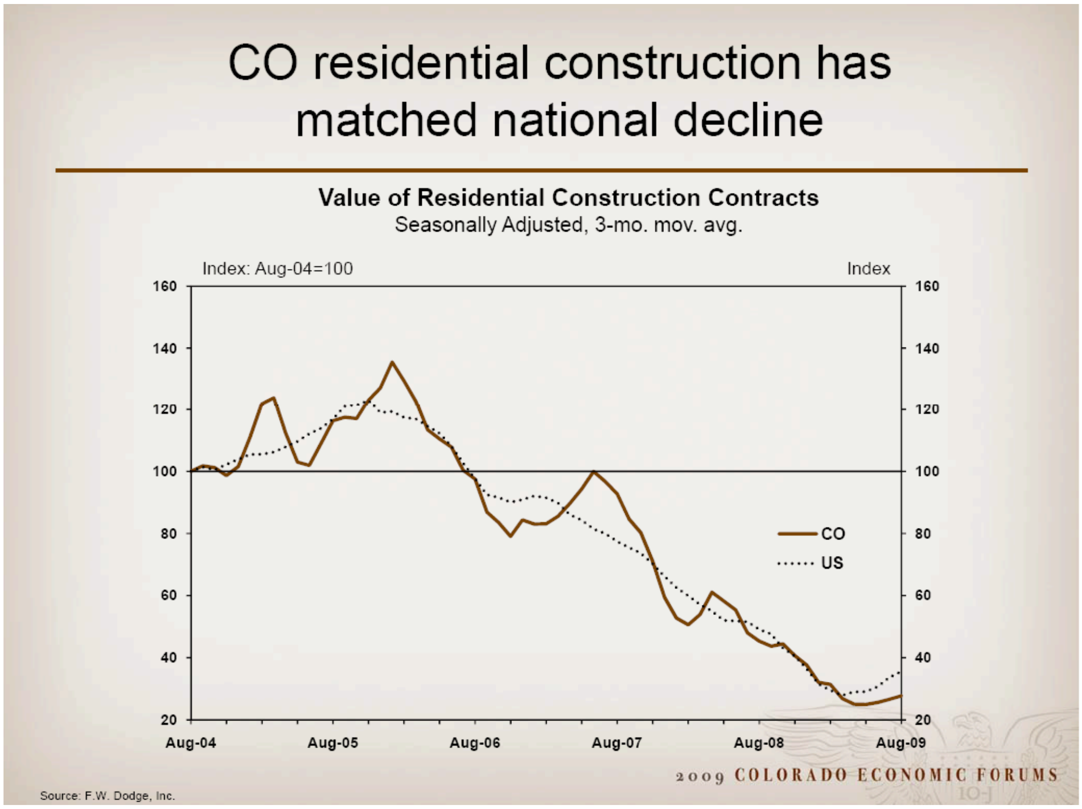
In October 1987 when there was a big dip in the US stock market, everyone thought how great the forecast of Ravi Batra was, and the Great Depression of 1990s was seen to be unavoidable. Sure enough, Prof. Batra was busy giving radio and TV interviews for many media sources all around the world. His book became one of the top sellers in the New York Times hit list, and he earned several million dollars from it. Like a fool, even I bought a copy and read it cover to cover!! Guess what? When 1990s arrived and ended, it became evident that Prof. Batra was totally wrong. The 1990s became the most prosperous decade ever in the history of US!!! So much for the forecast of Great Depression in 1990s!!! But don't forget that Dr. Batra became a millionaire due to it.

So, my point essentially is that no one really knows what is going to happen in future; how fast we can recover, whether we can recover at all and what will be the shape of the economic recovery. And let me add further that anyone who tells you with certainty, is outright lying to you, so be aware. Now, even if our ignorance about knowing the future with high level of certainty is granted, it should not stop us from analyzing why we are in such an economic mess and where did it come from? And there is a lot of help to us here, and also a lot of information that we can analyze.

Consider therefore some of the slides that I would like to show you here. In these slides it is clear that appearance of economic business cycles is not a new phenomenon, historically, US economy has always gone through economic fluctuations. But in term of the modern times, one can observe the increase in unemployment rate, reduction in construction job and other factors. These slides are by the courtesy of my friend Dr. Mark Snead at the Federal Reserve Bank of Kansas City, Denver branch.




Jobless rate in CO and most of district remains well below U.S.
Unemployment Rate, August 2009
Seasonally Adjusted
12.2%
13.2%
12.2%
6.0%
6.6%
7.3%
5.0%
7.1%
9.5%
15.2%
12.8%
10.8%
9.1%
7.5%
6.8%
8.0%
10.2%
10.7%
Legend
Less than 7%
7% to 8%
8% to 9%
9% to 10%
10% to 12%
Greater than 12%
U.S. Unemployment Rate:
August 2009: 9.7%
September 2009: 9.8%
Source: Bureau of Labor Statistics
2009 COLORADO ECONOMIC FORUMS



Historical Perspective:

Let us look at the historical economic growth in the US which probably can help us recognize why we are here. Actually, it could have all started in 1960s when the US economy broke the record of all earlier years and became the most prosperous decade ever. Therefore when Beatles were singing and hippies were dancing on the street, America was also producing goods and services at the fastest rate ever in the history of the country. This tremendous growth was mainly led by the manufacturing sector, with American goods taking over the world markets of automobiles, TVs, washers and dryers, refrigerators, telephones and many other products also especially in agriculture. The unprecedented growth of the 1960s was thus dominated by heavy production levels and the world dominance by the US firms.

Then came the shocks of 1970s especially in terms of oil price increase in 1973 (followed by another one in 1979). The country was also recovering from the losses in Vietnam War at this time. Other countries were learning to be competitive to the US firms in manufacturing sector, mainly Japan and Germany. All these changes fed into the cost of production creating an extra-ordinary recession of 1975. The late 1970s were the most turbulent time for the US economy. The stagflation of 1976 to1980 was a confusing phenomenon for the policy makers and theoretical Neo-Keynesians alike. In fact so important was the economic slowdown that the stagflation phenomenon prompted the Presidential candidate Ronald Reagan, to coin a new term of Misery Index. The Misery Index was calculated as Inflation Rate + Unemployment Rate. President Reagan used charts and pictures in presidential debates to show that the Misery Index had reached to the maximum in Carter Administration (1976-1980). He had a valid point however. By 1980, the unemployment had reached to 9% and the inflation had peaked at 14% in 1979. Interest rate, as measured by the prime rate in January 1981 was an all time high of 20.5% for all the major banks. Clearly this was a case of high interest rates leading to lower investment, higher unemployment and lower GDP. The unemployment rate stayed pretty high at 8 to 9 percent creating one of the strongest recessions (after the Great Depression) in 1982. (See the chart below that shows the changes in unemployment and real GDP).

Nonetheless, the recovery that followed after 1982 was so strong that by the time

1980s were over, it became the most prosperous decade ever, beating the record of 1960s. This recovery was led by computer revolution and the technological shift that boosted the economy as well as by the expectational changes that made all American to produce more. In fact, other factors such as the end of the cold war and stable gasoline prices also helped the USA re-establish its world's superior economic position one more time.

The magic of 1980s continued in 1990s, despite the fact that we have had a completely different political system in the USA. The democratic administration led by 2 successive terms, by President Clinton from 1992 to 2000, was politically different from the three terms of Republican Party administrations from 1980 to 1992. This political change however had no effect on the economic growth. The moderate contraction of 1991 was replaced by unprecedented growth of the economy after 1992. This was led by an amazing technological innovation in information technology, telecommunication, software and computer industries. So fast was the growth in this area that by 1996 it was fueling the stock market to the astonishing heights. You may have heard the stories of how the technology stocks were doubling themselves up even before the 3 to 4 hours of trading on the market. Added to the technological boost, there were the speculative investment activities and the high expectations of future growth, which made it seemed that there was no stopping to the stock market growth. Negative comments were easily discarded, the positivism was everywhere, the housing and stock market balloon was growing especially in late 1990s.

In 1999 the US Congress even passed the Gramm-Leach-Bliley legislation, allowing banks direct ownership of insurance companies, mutual funds, and other financial companies that further allowed Financial Institutions enter into the investment activities. This created additional buying power in the stock and bond markets, leading to their further increase. As incomes grew, so did the purchasing power and the housing markets experienced increased demand leading to tremendously higher housing prices. All along, the interest rate was declining, fueling the competition for selling the mortgages to eager or not so eager borrowers.

So, what went wrong? In my opinion, the answer is in two or three major events. First, of course the tragic and historical events of terrorist attack of September 11, 2001, and second, the tremendous expectation change that followed it. The optimism was slowly replaced by low expectations and pessimism, especially due to the lack of clear direction from a dragged up Iraq War, and aggressive fiscal and monetary policies. In many ways 200-2005 were crucial years for the economic chaos of 2008. In these years, the banks and mortgage companies became even more aggressive in term of lending activities. I remember the days when at around the dinner time, there would invariably a phone call (and mind well, there were no caller IDs at that time) where a pushy salespersons would ask us what our current mortgage was. It did not matter to them what our answer was to that question, they would always say, “oh we can do better than that”.

So fierce was the competition amongst the banks and mortgage lenders, that they offered loans that were much more risky, sometimes illegal and many times immoral. As people were pushed for the loans some consumers were more than excited to borrow at the levels that they not only did not deserve, but also they probably knew was unsustainable given their incomes.

Another idea of so called “smart” lending was the balloon housing loans which had a very small interest rate for first 4-5 years and then interest rate increased to a much higher rate. These balloon loans were popular amongst the borrowers who knew with certain high reliability that they could afford this loan (and therefore the house) only for first 5 years. Added to these the problems created by sub-prime lending and lending of the 110% of the house price meant there was further chaos in the housing market. Another interesting phenomenon was, what financial economists call, the advent of "Derivatives" which essentially mean the loans that are secured by some other loans. When the mortgage loans increased, so did the mortgage secured loans borrowed by banks and mortgage companies from not only from other US banks, but also from other European and Japanese and Chinese sources.

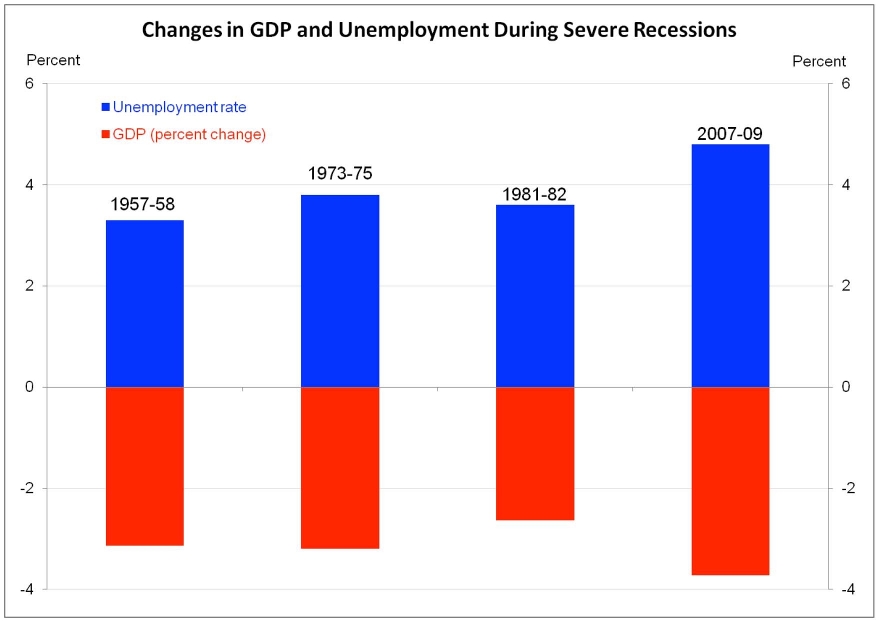
Hence, in this period the amount of new loans created was multiplying by several times, right under the watchful eye of policy makers as well as the politicians. Somebody at the high level should have pushed the panic button, but the expectational positivism was so high that no one dared to warn the system in time. In fact, the policy responses were so benign that the monetary policy further aided the chaos by lowering interest rates to close to 1% on the discount rate. In years 2007 and 2008, the evil effects of this irresponsible behavior were evident.

As the balloon loans matured, and more and more home owners realized that they cannot sustain the payments, they put the house on the market. Even in my personal case, I had a house of roughly $330,000. In 2002-2003 period, the banks were so aggressive in giving loans that I was offered a loan of $354,000 on that house. When time came to sell the house in 2004, our only one offer for the house, after waiting for 6 months in the market, was for $309,000. This meant even after selling the wonderful house, I was liable to pay-back to the bank roughly $40,000!!!

Now, I am a poor but honest Economics professor and my wife is a poor Accounting professor, so we went with the deal, and we kept our credit flawless to borrow some more loans to buy our next house. But imagine people who would not be able to do that. They had to foreclose the house to save themselves from the losses, and by 2008 naturally, the rate of foreclosures skyrocketed. Added to this decline in demand for houses, there was the tremendous housing construction wave which created excess supply of houses all over the USA, especially in such states as California, Florida, Illinois, Michigan and Ohio. As house prices plummeted, foreclosures increased further, and we started a crisis that became of a monstrous proportion by September 2008.

Also, recognize that housing loans were used as collateral to borrow some other loans and defaults of the housing loans created a string of further defaults. This created a "crisis of confidence" as more and more financial investment firms admitted that they have whole lot of more liabilities than they have an ability to pay back. The cases like Smith Barney, Ginnie Mae and Ginnie Mack, and Lehman Brothers made it abundantly clear that we had a strong and fearful crisis at hand. In October of 2008 the government officials such as the President, Treasury Secretary, the Federal Reserve Board Chairman recognized that there is, what economists call, a "Systemic Risk" which means the whole financial system was at the risk of collapsing. Observe the following chart which will explain the severity of the current recession in comparison with other recessions after the Great Depression. In terms of both GDP decline and unemployment rate increase, the last 2 years are more drastic than any other years before.

Current recession: Worst post-war



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Something special had to be done, so as the first step, the US Congress passed Troubled Asset Relief Program (TARP) bill (signed immediately by President George W. Bush) which allowed a one time spending of $750.00 billion.

Policy Responses in Last Two Years:

As I mentioned before, through out the financial crisis (and even before few years) the monetary policy behavior (as well as fiscal policy behavior) was pretty interesting. While monetary policy kept lowering the interest rate, making it easier for Financial Institutions to borrow from Federal Reserve Banks, it also allowed the liquidity to increase and overall it was expansionary monetary policy. This seemed logical as the inflation rate in all these years was at a moderate of 5%, and there was no reason to reduce the money supply growth rate. As the crisis hit, the Federal Reserve System as a unit, declared that it is ready to help the disturbed financial system in whichever way possible including offering more loans to the troubled banks. Besides giving more loans monetary policy makers could not do much, as they were confused by the advent of the crisis in the first place.

Fiscal policy was even more confused and confusing. The TARP money was supposed to save the crisis by giving extra loans to the banks and financial institutions that were having problem of survival. However this was a great price to pay in terms of the amount of spending by the US government. Mind well, that the government expenditure in whole 2008 was roughly $2800 billion and the TARP program was authorizing additional $750 billion in one shot. What was even more mind-boggling was the behavior of the Obama Administration, when president Obama came to the White House in January 2009.

Armed with clear majority in the Congress and a minor majority in the Senate, the democratic administration held no bars to further boost to the economy. In March 2009, an additional bailout package, in terms of the stimulus money, was passed of roughly $787 billion. This meant that the US government was spending whopping $1500.00 billion in a mater of 3-4 months with just two spending bills.

An interesting thing happened in April 2009 in my personal life too. In a speech, at around this time, President Obama mentioned somewhere that "All economists are in favor of the new stimulus budget". Well, the Cato Institute of Washington D.C. which is a conservative think tank, took a serious exception to this assertion. So, they sent me an e-mail, just like they sent it to many other like-minded economists, which said that if you want to sign a declaration, "With all due respect Mr. President , we disagree. Even the Great Depression was not solved by tremendous spending on the part of the US government etc". Well, I was always thinking, and telling my students in my classes, that this spending in just 3 months is way too much spending, and it may come back to haunt us in future, so I readily agreed to sign that Cato Institute e-mailed declaration. In a few days afterwards, there were 200 economists including some Nobel Prize winners, who signed that letter to the President. Interestingly, the Cato Institute rented a whole page advertisement in all major newspapers including Wall Street Journal, Washington Post, New York Times and some others, to publish this "Open Letter to the President".

As my luck has it, in the order of their printing, my name and institution happened to be right smack in the middle of the list at the top of the page. Well, I started getting phone calls from reporters in New York, Chicago, radio talk hosts in Denver area and even the Indian weekly called India Abroad!! In a mild sense of the term, I was a celebrity!!! They all wanted me to explain the consequences of such a tremendous expenditure by the government, a justification which can easily be done by a rational macro-economist. Just imagine what will happen when the government has to finance this extra expenditure. Of course, the government's budget deficit will skyrocket. But in case of US, it already has. The 2008 budget deficit was roughly $480 billion and we already know the 2009 budget deficit, because US administration budget goes from

October to October, which is $1400 billion. This brings in the important question: When government has to spend $1400 billion worth more than the tax revenue, where does the extra money come from? There are two ways to accomplish that: One, to sell bonds to the public, get their money and spend it. Well, the US Department of Treasury is very good at doing that. In fact, whenever the deficit occurred, a large portion of it was financed by selling bonds to the public, which creates, what economists call, public debt or national debt. The national debt for the US government has already reached to a whopping $12 trillion (which is $12,000 billion) because from 1969 we have had a lot of deficits to finance by selling bonds to the public.

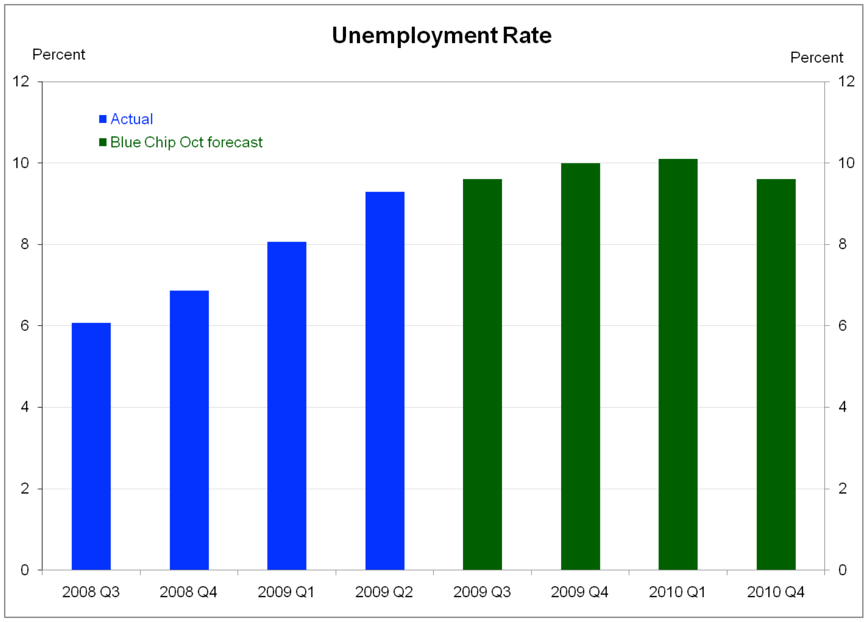
Hence there are all signs to see that this national debt will further increase. The current administration thinks that this added creation of national debt is all worth it for the assumed the economic recovery they would bring. Therefore, here is a good analogy to consider: If you had two types of fathers, which one would you like more? The one who says, I can satisfy all your demands by borrowing more and more from a bank and leaving you a debt of $ 1 million when he dies, or the one who lives very conservatively and says almost always “No” to every demand you make from him? I guess the economic recovery will be borrowed if we pay no attention to the problem of national debt. In a way, no politician (except a Texas billionaire named, Mr. Ross Perot) considers this problem to be of great importance, because they all worry about the current state of the economy and they apparently let the future generations worry about the debt. Now, that is game my generation in USA is playing, we just postpone our debt problems to the future generations, and if our children are as smart as us, they will postpone the debt to their children!!

And let us not blame only the current administration for this. Right form 1960s every administration with out fail has added more to the national debt to reach to the current astonishing figure of $ 12 trillion. Thus, this humongous budget deficit will add pressure on the national debt problem.

Second, the government (or the branch of the US government, The Federal Reserve System) can just be pressurized to print more dollars to finance this added expenditure. However, creation of higher currency would in all probability, create inflation problem. Look what is happening in many of the countries in the world. When governments allow money supply to increase irresponsibly, such as in Brazil, Argentina, Zimbabwe, Indonesia etc they face the problem of hyperinflation. Now, it is unthinkable that the Federal Reserve can go to that low level, but even an excessive increase in dollar supply can bring a threat of inflation. While that is an anticipated move, there is no such thing happening as yet in US. This, however has effect on the value of dollar in international market where expectations of future exchange rate are quite important. As you know, the dollar value has already depreciated significantly in the last 3 years, we can expect it to continue that decline in dollar value in near future. You may ask then why is it not getting less valuable to India Rupee? or Should we, the dollar holders, not be investing more in India? The answer is Yes, many have already done that, but if Indian economy is not expected to continue growing at the same speed and if Indian expected inflation is not low, there is no point in changing the dollars to India rupees right away. In my opinion that is the reason for relatively low current value of Indian rupee.

So, let me conclude by making some short term predictions, even if I promised you that I will not do so in the early going. My first prediction is that the economic recovery for US economy is not happening in the immediate future, the national debt problem is going to get worse and the inflation is expected to increase especially if the monetary policy monetizes this tremendous budget deficit. But, then again, all those 200 economists (and I) warned about this back in March 2009 anyway. So in some sense, I am not saying anything new to you which I did not say before.

Thanks again for your undivided attention and your time. It has been a marvelous experience to visit Mysore, and I definitely look forward to coming back in near future. Thanks again to Dr. Bisalaiah for being present here as well as for his generous gift to the economic profession. I conclude by showing you my last slide of unemployment in USA and by getting ready to answer your questions.


Unemployment Rate
Percent
Percent
12
10
8
6
4
2
0
Actual
Blue Chip Oct forecast
2008 Q3
2008 Q4
2009 Q1
2009 Q2
2009 Q3
2009 Q4
2010 Q1
2010 Q4

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* About Prof. Kulkarni

Kishore G. Kulkarni was an outstanding student, as he secured the First Rank in B.A. (Economics) Examination (1974) and Second Rank in M.A. (Economics) Examination (1976) of the University of Poona (Pune). With the help of teaching assistantship at the University of Pittsburgh, he completed M.A. (Economics, 1978) and Ph.D. (Economics, 1982) degrees. He has been teaching Principles and Intermediate Macro- Micro, International Economics and Monetary Economics and related courses since 1980. Prof. Kulkarni has worked with University of Pittsburgh-Johnstown, University of Central Arkansas, University of Louisiana-Monroe, University of Colorado-Boulder, Colorado School of Mines, Korbel School of International Studies at the University of Denver and Metropolitan State College of Denver. In all these institutions, students have rated him as one of the exceptional professors, and have praised his teaching style in many different ways. He received the "Outstanding Teaching Award" by Golden Key International Honor Society in 2001. He has taught in Semester at Sea Program of University of Pittsburgh in Spring 1994, and has made several visits to lecture in India. His unsaturated love, unlimited energy and enthusiasm for teaching make his classes exciting, entertaining and rewarding.

Prof. Kulkarni's prolific research record has produced over 95 journal articles and 7 books. His first book, now in the fifth edition "Principles of Macro-Monetary Economics" Kendall/Hunt Publishing Company, (2009) has been used as a textbook in USA since 1986. Besides, Prof. Kulkarni has co-authored (with Edvin Dolan) two other famous textbooks for Principles classes, "Understanding Microeconomics" and "Understanding Macroeconomics", both with Horizon Textbook Publishing, Redding CA (2007), that are used at numerous US universities. His "Simplified Macro-monetary Theory", Serials Publications, New Delhi (2006) has been a popular adoption in Indian Universities. He has also co-edited (with Penelope Prime) a book on India and China (Serials Publications, 2007).

His simple and understandable writing methods have earned him "Outstanding Researcher/Scholar Award" of Golden Key International Honor Society in 1997 and "Outstanding Contributions to Professional Development Area Award" of the School of Business of Metropolitan State College of Denver from 1996 to 2004. For all the professional and service contributions, he was also given "Distinguished Service to the College and Community" Award by the Faculty Senate of the MSCD in 2004.

Prof. Kulkarni is the founding Editor (with Bansi Sawhney) of Indian Journal of Economics and Business (www.ijeb.com) that is a refereed, international journal in economics and business. More information about his books can be found at www.kulkarnibooks.com.