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**Moving from Economic Recession to Recovery: A Case for Economic Growth Risk (EGR)
Strategic Management Model**

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MOVING FROM ECONOMIC RECESSION TO RECOVERY: A CASE FOR ECONOMIC GROWTH RISK (EGR) STRATEGIC MANAGEMENT MODEL

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Abstract

This paper argued that strategic government policy catalysis effects at engineering economic growth have Economic Growth Risk as side effect and there is need for Economic Growth Risk to be strategically managed to achieve long run path to economic growth.

Key Words:

Economic, Growth, Risk, Strategic, Government, Policy, Recession, Recovery

“Every continent must contribute to a global bargain to lead the world out of recession and nobody could have predicted the economic hurricane”

UK Prime Minister- Gordon Brown, (Metro, February20 2009.p5)

Introduction

Most advance economies were declared to be in recession as of December 2008 with United States entrance into state of economic recession in December 2007. These declarations means there is a general slowdown in economic activities across countries over a sustained period of time defined to be two quarters of negative real economic growth. There is the notion that economic recession is foreseeable but they are generally not detected until already in motion, one might argued that the foreseeability attribute of recession within economic cycle is link to the process of economic growth loss. So, when contraction kicks –in within the cycle, the economy starts to loss its growth and when full contraction takes place then we have economic recession. While restoration of growth into the cycle kick start the process of economic recovery and after a period in an economic cycle of recording positive real growth imply a state of economic recovery. In other words, economic recession is preceded by economic growth loss with the lost and found of economic growth attributed to the natural tipping and balancing of key macroeconomic variables as money supply, interest rate and inflation in an economic cycles . It is the tipping of this delicate balance that force the economy to correct itself by creating natural changes in consumer spending and consumption, prices of goods and labour (Reccesion.org, 2009). The point is that if the economic cycle contraction is caused by the natural forces of market, then market has been proven to be capable of making natural adjustment that would restore economic growth in to the cycle. In most instances, instead of the economic cycle entering into a state of recession, it would be an economic panic. The question one might ask is that, if economic growth is induced in to economic cycle by strategic government policies (SGP) and in the same process the achieved growth is lost, is it correct for Government to leave the task of economic growth restoration back into economic cycle to Market forces alone?

The period year 2008-2009 mark entrance of advance, emerging and developing economies into a state of economic recession as global GDP contracted by 5 percent at an annualised rate. Governments have been responding at containing the recession by adopting expansionary macroeconomic policies, such as increasing money supply, increasing government spending and decreasing taxation. However, IMF assessed that despite major stimulus packages implemented by advance economies and several emerging markets economies, trade volumes have shrunk rapidly. The data on production and employment suggest that global activity continues contracting from 2008 into the first quarter of 2009 and its projected that the world output would contract by 0.5 to 1 percent in 2009 on an annual average basis – the first of such fall in 60 years (IMF, 2009). The aggregate of countries economic cycle contractions translate into global recession. Global recession is a period when global growth is less than 3 percent and there is an

estimation that global recession occurs over a cycle lasting between 8 and 10 years. By this measure, 2008-2009 qualify to be identified as global recession period following after the order of three periods 2001-2002, 1998, and 1990-1993 based on economic crisis of the last three decades (Rogoff, 2002). Having established that there is global economic growth loss that triggered the current global recession and strong evidence of strategic government interventions to contain the recession, it is worthwhile to know what role strategic government policies (SGP) played at inducing global recession 2008-2009? To know the role of Government, recession vicious cycle was produced to aid understanding of the analytic review of issues within the cycle. The review provides this essay with theoretical explanation behind global recession in relation to Economic Growth Risk and opportunities at its identification and management towards prevention of global economic growth loss.

Strategic Government Policies (SGP) Engineering of Global Recession 2008-2009

The cross-sectoral government interventions at containing the current recession portrayed Market system as a failure and makes Government look more of a scared cow (Demirgüç-Kunt and Luis Servén, 2009). Whereas, it is the catalysis effects of strategic government policies that led to the creation of complex vicious cycle of sectoral crisis which triggered off the global recession (Taylor, 2009). To support this assumption, we depict a version of the recession causative vicious cycle to identify at which point within the cycle that SGP act as stimulant to recession engineering process.

Fig 1. Recession Causative Vicious Cycle and Strategic Government Policies (SGP)

Figure 1 show how SGP engineered the global recession 2008-2009. The vicious cycle started with the cheap investible credit. This was facilitated by monetary policies of Central Banks to create excessive quantities of cheap credit by setting interest rates below where they would be set by a free market (Garrison, 2006). It is at this point the credit market was stimulated to increase accessibility to credit; this process was catalysed by strategic deregulation of financial system. This provides incentives for overleveraging by Banks through opening up chances of achieving high returns on capital (Reisman, 2008; Felsenthal, 2008). Although, the over all objective of the SGP is to stimulate economic growth by removing barriers to access to finance. The Housing sector was strategically targeted for growth with Federal Reserve opposition to regulation of derivatives (Mortgage-backed Security), the SGP pushed the Banking System to expand mortgage credit and advance riskier loans aimed at helping the stagnated home ownership (Ron, 2003). The result is the malinvestments in housing projects and consequence housing market bubbles and market driven increase of consumer credit. The increase in available consumer

credit led to global overconsumption of energy and food with Energy crisis and Food crisis as the consequences (Rubin, 2008). Furthermore, figure 1 show no Government intervention at the crisis level and at controlling unemployment driven by cost of economic growth (Jones, 2008). The position of this essay on non-government intervention at the crisis point as depicted by road map to recession above was supported by view expressed by Taylor (2009) that the unpredictable nature of government's response to the crisis created deep and worsened state of economic condition.

It was at the point of prolong inflation that Government took up responsibility for inflation management. In attempt to control inflation, Federal Reserve tighten up monetary policy by raising short term borrowing rates resulting into reduced demand for long-term borrowing. This SGP effects brought to an end the period of prolonged positively sloped yield curve and a start of period of yield curve inversion (Taylor, 2008; Taylor 2009). As Banks at positively slope yield curve period were funded by cheap money and made profits by lending out at higher long-term rate. The Banks lend to Housing market using Li's Gaussian copula formula for investment risk calculation. The formula allows Banks and investors to take systematized risks by taking advantage of low interest rates to borrow tremendous sums of money; however the Banks could only pay back if the Housing market continued to increase in value-asset price inflation (Salmon, 2009). So, the yield curve inversion by the Government creates a liquidity risk (Economic Growth Risk variable) and Banks have to refund at expensive short term rates while losing money on longer term loans in addition to increase rate of default assets driven by unemployment. This led to subprime Housing lending crisis (Dodd, 2007). The cracks in the Banking formula allow for subprime lending as it does not took into account drastic yield curve inversion by Government as well as miscalculating risk inherent in the unregulated collateralized debts obligation and credit default swap markets. The result was that global banking system lost trillions of dollars in the process of yield curve inversion link up with miscalculation of investment risk (Caprio et al 2008). This led to bursting of the housing bubble as money flowed out from the Housing market into commodities. The massive, practically unthinkable losses dramatically impacted the balance sheets of Banks across the globe, leaving Banks with little or no operation capital (FT, 2009). The result is global Credit Crunch, a mark of state of Economic Recession.

Undoubtedly, the Government catalytic actions were at background though not very visible to the public in comparison to deficiencies in operating risk management formula of the banking system. While scape goating the banking system for the global recession might not be absolutely correct (Caprio et al 2008), it would suffice to say that Government should hold there hands up and take part of the blame for engineering incentives for market to take risk at advancing Economic Growth without Government consideration for adverse impact of risk undertook by market system on Economic Growth.

Recession and Economic Growth Frameworks Linkage Gap

From above discussion on the role strategic government policies (SGP) played in engineering the global recession 2008-2009, it is evident that the primary goal of Government is Economic Growth. In pursue of economic growth, they have to deal with Cost of Economic Growth and remove the barriers to access to Finance for Economic Growth. This section open up discussion on the theoretical linkage of economic growth frameworks in order to provide insight into the existence of gap within the frameworks Linkage as it consequence to recession.

Fig 2 Economic Growth Frameworks Linkage minus Economic Growth Risk

The theoretical discuss progress by putting depicted frameworks in figure 2, at the centre of scholastic views expressed on the relationship between economic growth and government policy. There is an implicit

suggestion that more growth is a good thing, and more human capital, investment and productivity is the way to get it (Williamson, 2000). It has been empirically proven that there is a link between government policy and aggregate economic performance measured by growth rate in or level of income per capital (Besley, 2000). This linkage justifies the assertion that countries push for long-run path to economic growth by encouraging exponential kind of growth through the use of strategic government policies SGP (Freeman, 2000). While there is a consensus that government policies that strategically encourage economic activities by improving productive capacity to take advantage of economic of scale and allow more money to change hands without encouraging rise in the general level of prices is highly desirable. However, it has been viewed that consideration should be given to end-of-period position of the economy at the point of enacting government policy (Williamson, 2000).

Moving to Financing for Economic Growth, it has been argued that robust financial sector with minimum of crisis is essential for growth, so the importance of getting financial policy decision that drive economic growth right has emerged as key development challenge. In respect to this challenge, policy efficiency provides incentives that limit undue risk-taking and fraudulent behaviors in the management and supervision of financial intermediaries. While financial policy laxity that provides incentives for taking on high risk investment in expectation for high return on capital make financial market instability inevitable. The Banking crisis frequencies confirm the effect of SGP on financial market instability and a reflection of unregulated risk taking capacity of the Banks going well beyond society's risk tolerance. Banking failure costs are very real to the public as they are tax on growth (World Bank, 2001). So, SGP has got other side in terms of policy uncertainty in relation to financial investment opportunism and return on investment pure uncertainty, which are Economic Growth Risk variables. These variables need to be strategically managed to achieve sustainable path to long term economic growth (Williamson, 2000). Having said that finance is the driving force behind growth, there is Cost to Economic Growth. This has been proven to have first-order consequences on economic growth framework. The consequences are due to SGP effects in management of cost of economic growth. It implied that nations has to make key decisions about Economy Safety in relation to Environment and Health versus flow of Capital and Trade, if catastrophic risk is to be prevented. Further, it has been argued that economic growth leads to a disproportionate concern for safety as developed nations are tightening their regulations on production of goods using substance with tragic health consequences, production using same substances move to less developed countries. The policy differential in ensuring economy safety has implications for international trade and international relations in general as it creates Economic Growth Risk effect, if economic safety threshold is not strategically managed (Jones, 2008). Therefore, Economic Growth Risk effect of strategic government policies from both end of finance and cost of economic growth need to be strategically managed to avoid creating gap in the framework linkage. For the gap due to missing Economic Growth risk reduces the productive capacity of capital and labour and the end-of-period position is Recession as currently experience globally.

Recovery and Rethinking Economic Growth Model

The fact is that strategic government policies (SGP) of the last decades had driven nations endogenous growth model to increase global productive output, which is reflected in increase consumer consumptive confidence, access to finance and jobs. For example, Japan economic growth model has been endogenously driven through cross-sectoral government policies on productivity improvement, technological innovation and co-development of Asian countries towards enhancement of international trade competitiveness to achieve exponential growth target of 2.2 % annually (Sakata, 2007). The recent global crisis does not spare any nation as from US, Japan and Europe economies are in recession with China though not in recession but experiencing GDP rate slowdown from 11.4% in 2007 to between 8% to 9% range in 2008, the slowest rate in seven years. Africa countries are made vulnerable because of fall in commodities demands as annual 5% growth enjoyed by sub-Saharan Africa is been wipe off as a result of recession, making poverty reduction targets for countries unattainable (IMF, 2009). Against the understanding of how growth achieved has been wipe off across countries in relation to recent global recession, it can be argued that SGP effects on endogenous growth model is two sided - economic growth

rate increase and Economic Growth Risk. *By Economic Growth Risk, we mean the possibility of economic crisis or failure arising from engineering economic system through strategic government policy effects on finance for growth and cost of growth.*

The question is how to manage growth risk induced by policies that enable incentives for entrepreneurial risk taking (Demirgüç-Kunt and Servén, 2009); when place on the balance that regulating entrepreneurial risk incentives may retard or promote economic growth depending on financial and cost of economic growth policy assumptions considered (Jones, 2008; Miguel-Angel Galindo^Sotos et al, 2007; World Bank, 2001). For instance Demirgüç-Kunt and Servén (2009) queried the policy assumptions underpinning monetary policy target of asset prices that contributed to recession 2008-2009 and are critical of bail -out and regulatory policies focus on liquidity flow within the financial system to induce recovery process without consideration to Economic Growth Risk effect on aggregate output. They argued that even in the midst of a financial crisis, it is inefficient to set aside long-term goals completely as the manner in which a crisis is resolved affects the frequency and depth of future crises. Further, they stressed that if institutions can count on crisis resolution to be mis-managed, they will be more willing to risk insolvency with safety-net subsidies mainly flowing to institutions that take excessive risks at the expense of taxpayers and market discipline.

The above discussions point to need for regulators to encourage development of financial market and instrument that would help in more accurate assessment of risks, both in and out of crisis situations to forecast on future economic growth rates and design correct policies stances (Brunetti and Torricelli, 2005;World Bank, 2001). It is the concern for Economic Growth Risk effect of SGP induce move from recession to recovery that led to the call for alternative strategic government policies underpinned by social costs and adverse distribution effects assumptions for managing the recent economic crisis at containment, recovery and long term resolution stages and structural reform that follows recovery (Demirgüç-Kunt and Servén, 2009).

The argument is that for economic growth rate to be accurate, the forecasts need to take into account Economic Growth Risk factors as it relates to societal risk tolerance limit and economy safety threshold (Jones , 2008: World Bank, 2001). The concern about accuracy of economic growth model forecast was a dominant feature of growth literature during the 1980s and 1990s as economist sought after new model that would facilitate consideration of new variables in growth analysis to provide a broader perspective of economic growth process (Miguel-Angel Galindo^Sotos et al , 2007). The emergence of endogenous growth theory in the late 1980s brings about replacement of neoclassical analysis generalisation of Technology as function of “Residual” factor in the model with Government Policy. Endogenous growth analysis tend to predict that growth will be faster or slower depending on costs and benefits of knowledge –creating and innovative activity, which Government Policy can influence in various ways (Freeman, 2000). However, in taking theory to data there is the task of explaining residual (multifactor productivity) - that part of the change in economic growth rate that is not explained by increase in capital and labour (Besley, 2000). Further, Besley (2000) expressed that though a large literature has developed in recent years that considered empirical determination of policy effectiveness, the assessment of policy variables in the growth model is still a problem. Therefore, as a guide to assessment of policy variables, the literature is rather inconclusive and better guide for policy is needed. This policy variable needs is confirmed as Capiro, Demirgüç-Kunt, Kane (2008) stressed that it is superficial to blame economic crisis that triggered recession 2008-2009 on market –to –market accounting, an unexpected loss of liquidity or trends in globalisation and deregulation of financial market earlier discussed in this essay. They argued that the principal source of financial instability lay in contradictory government policy incentives that undermine the effectiveness of financial regulation and supervision around the world.

Against understanding that economic growth rate forecast accuracy dependence on policy variable assessment, it could be argued that Government Policy treated as externalities locked up in “Residual” has both economic benefits and cost. At present scholars are finding it difficult to empirically assess policy effects in relation to economic benefits and cost impact on growth rate. We are argued that the resultant policy uncertainty produces Economic Growth Risk, the other side of Government policy and that it’s currently locked up in the “Residual”. We propose an Endogenous Economic Growth model in a very simple

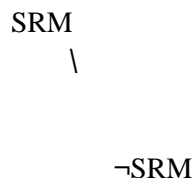
form to reflect the addition of Economic Growth Risk factor without reference to changes in relationships within the model.

The basic form of a typical endogenous growth model, where we are coming from:

- 1) $EG = H + T + (L)(K) + R(f(GPI))$, where EG is economic growth rate, H is human capital, T is technology, L is labour, K is capital and R is Residual (f) –function of (GPI)-Government Policy Incentives. Model (1) takes us to model (2) where we are at the moment:
- 2) $EG = H+T+ (L)(K) + R(f(GPI), (\pm EGR))$, where residual function EGR –Economic Growth Risk is included.

By making Economic Growth Risk dependent on economic forces in the same way technical changes was released from the lock of residual, we argued that EGR variables includes costs incurred to move the economy back to recovery from recession stage would not be difficult to empirically assess. If EGR is factored in to the growth model, this would improve the accuracy of economic growth forecast. As countries would be aware through the framework, the danger inherent in not strategically managing risk associated with their SGP. Since, there is nothing in economics that limits the inputs in growth equations to capital and labour- (augmented by human capital and technology) by way of conventional measurement. And the best way to deal with residual problem still remain adding additional inputs to growth equation with the impact of multitude of additional variables that analyst have added to growth equations in recent years has produced wide range of results (Freeman, 2000). We depict with figure 3 below that adding Economic Growth Risk that is strategically managed would provide a long-term economic growth frameworks linkage as the gap in figure 2 that led to recession would be closed, where SRM is strategic risk management.

Fig 3 Economic Growth Frameworks Linkage plus Economic Growth Risk



The propose model that would take us to where we are going is stated below:

- (3) $EG=H+T+ [(L) \pm EGR] [(K) \pm EGR] + R(f(GPI))$, where the factors remain as defined for the previous models. For model (3), the point to stress is that (\pm) call for strategic risk management (SRM) to enable countries to reap SGP benefits and not cost, and to mention that the effect of EGR on productive capacity of labour and capital are mutually exclusive.

Conclusion

The strategic government policy stimulation of growth contributed to recession 2008-2009. One major reason for this negative policy effects relates to “Residual” problem within the growth model. The Government Policy produces a side effect in terms of Economic Growth Risk factor. This factor is currently missing within the model, and its makes forecast inaccurate and in turn negatively impacting policy decisions on economic crisis contingencies planning and management. As the global community moves from a state of economic recession to recovery, we argue for the rethinking of the endogenous economic growth model by opening the “Residual” door for the addition of Economic Growth Risk factor into the growth model. The propose growth model version is suggested at improving accuracy of growth

rate forecast, economic crisis forecast and to enable better strategic government policy risk effect management.

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Cheap Investible Credit

Credit Crunch

Mortgage Credit

Consumer Credit

Mal-investment in Housing Market

Overconsumption

Sub-prime lending Crisis

Unemployment

Commodity Crisis

Inflation

SGP

SGP

SGP

SGP

Recession

Economic Growth

Cost of Economic Growth

Financing For Economic Growth

GAP

RISK

RISK

Economic Growth

Economic Growth Risk

Cost of Economic Growth

Finance for Economic Growth

Economic Growth Risk