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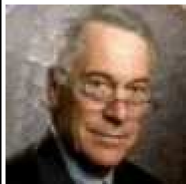
Be in commodities, emerging mkts till Feb '10: Steve Hanke



Many economists including Paul Krugman and Robert Shiller have said that the US economy desperately needs a second stimulus. However, Steve Hanke, Professor of Applied Economics, Johns Hopkins University, and a senior fellow at the Cato Institute, holds a different opinion. He says there should never have been a fiscal stimulus in the first place.

According to him, commodities and emerging markets are the place to be for the next six months. "Looking at the market chart of Mumbai versus the US, Mumbai is way up there, so are other emerging markets, and I think they will stay that way."

Here is a verbatim transcript of the exclusive interview with Steve Hanke on CNBC-TV18. Also watch the accompanying video.

Q: I know you are of the view that the US economy will experience a W-shaped recovery and you are critical of the Fed's ballooning balance sheet and the rising fiscal deficit. Everyone's including you say's that today's solutions to the global collapse could probably pose tomorrow's problems. How else could we have prompted a recovery if not for fiscal stimulus packages?

A: I think the recovery normally and typically from a very sharp panic as we had in 2008 would lead to what is called the V-shaped recovery, a very sharp recovery. Worldwide now we have this V-shaped recovery that we normally have. The reason that we are not getting it is because people are scared about the regime and certainly with the new administration. They are scared about the huge increase in government expenditures and prospective tax increases and also because of fellow reserve as the massive expansion in balance sheet. So as a result they are kind of hunkered down not spending any money and trying to save as much as they can. That's why the recovery is not a V-shaped, it's muted. In the US, we are all recovering but it is much slower than normal due to these three factors that I just gave you. In a Keynesian sense, the fiscal multiplier just isn't working; it is negative because the expansion has been so massive.

If we jump back to the stimulus methodology, look at Germany the Chancellor Merkel was very reluctant and resistant to huge stimulus packages. And, as a result, surprise, Germany is the first European country that starts looking like it is going to come of the recession. Everyone was hammering Merkel and saying, “Oh! You are not doing what Keynes said are not stimulating and you are not running a big deficit and this is going to be a disaster for Germany.” Well it turned out just fine. Two days ago, we got results from a really snap back in Germany. So in the US, fiscal stimulus was a way too big and it is slowing down, it is not stimulating and the Keynesian multiplier actually negative so the stimulus packages is so huge that it scared everybody and they are afraid to spend money and it is slowing things down in United States keeping a cap on things. So, all this stimulus thing was absolutely the wrong thing to do. They should not have stimulated and we would have had in United States. If they would not have done anything we would have had as always had after a big panic. We would have had a V-shaped recovery.

Q: Many economists are asking for a second stimulus package, what you seem to be suggesting is, let Central Banks start tightening, again something that most economists advice against and that there should have been no stimulus whatsoever.

A: There should not have been fiscal stimulus—they were the wrong thing and the fiscal multiplier in the US is negative and not positive. On the monetary side, as early as 2007, they should have loosening monetary policy in the US, they should continue to keep it loose until the money multiplier picks up the money multiplier—M2/Monetary Base—usually between 8 and 9, after the collapse went down to 4.5-5. So they have to keep the monetary pedal to the metal until the multiplyer starts turning around. And then, they have to start exiting very rapidly and fighting the expansionary impact of an increase in the money multiplier and that hasn't happened yet. I didn't say they should be tightening right now; they should be tightening when the money multiplier goes back to normal levels, and they will have to get out very fast, otherwise they will have inflation.

But as I said earlier, they will wait too long for political reasons. We have a November 2010 Congressional election coming up, and the fed will be reluctant to exit before that, but it might be too late—inflation might be breaking out. But if they fight it after that, it will have to be aggressive, and that might tip us back into a recession as they fight it.

Q: How should businesses plan for the near future? Show they hunker down and wait for the second leg of the W-Shaped recovery that you are talking about? And how should investors plan for the next 6 months both for the equity and the commodity markets?

A: The next six months is easy, that is before the W-shape kicks in and you have another recession. Commodity markets are going to be strong. I like a lot of Emerging Markets. I do not like the US market. And, if you look at Mumbai, the stock market has roared since March, compared to the S&P 500. People in the US think its terrific the way the US markets have bounced back. But if you look at the chart of Mumbai versus the US, Mumbai is way up there, so are other Emerging Markets, and I think they will stay that way. So commodities and emerging markets are the place to be for the next six months.