HOW DEEP IS A CRISIS?

POLICY RESPONSES AND STRUCTURAL FACTORS BEHIND DIVERGING PERFORMANCES.

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Who are the editors?

- Jean Paul Fitoussi

Professor of INSTITUT d'ETUDES POLITIQUES de PARIS
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President of OECD

His studies are focused on Inflaction theories, unemployement,
Foreign trade, role of macroeconomic policies.

Has provided numerous contributions in debates of current economic policies, in particular in economic integration theme and transaction.

Who are the editors?

- Francesco Saraceno

He’s a senior economist of OECD.

Professor of COLUMBIA UNIVERSITY

LA SAPIENZA UNIVERSITY in Rome

Works for OECD

His main research interests include the relationship between inequality and macroeconomic performance, european macroeconomic policies and interaction between structural reforms and fiscal and monetary policies

WHAT IT IS THE OECD?

Organisation for Economic Co-operation and Development

Is an international economic organisation of 34 countries founded in 1961 to stimulate economic progress and world trade.
It is a forum of countries committed to democracy and the free-market economy, providing a platform to compare policy experiences, seek answers to common problems, identify good practices and co-ordinate domestic and international policies of its members

Introduction

Debate beween

1. **who think that the crisis is now behind**

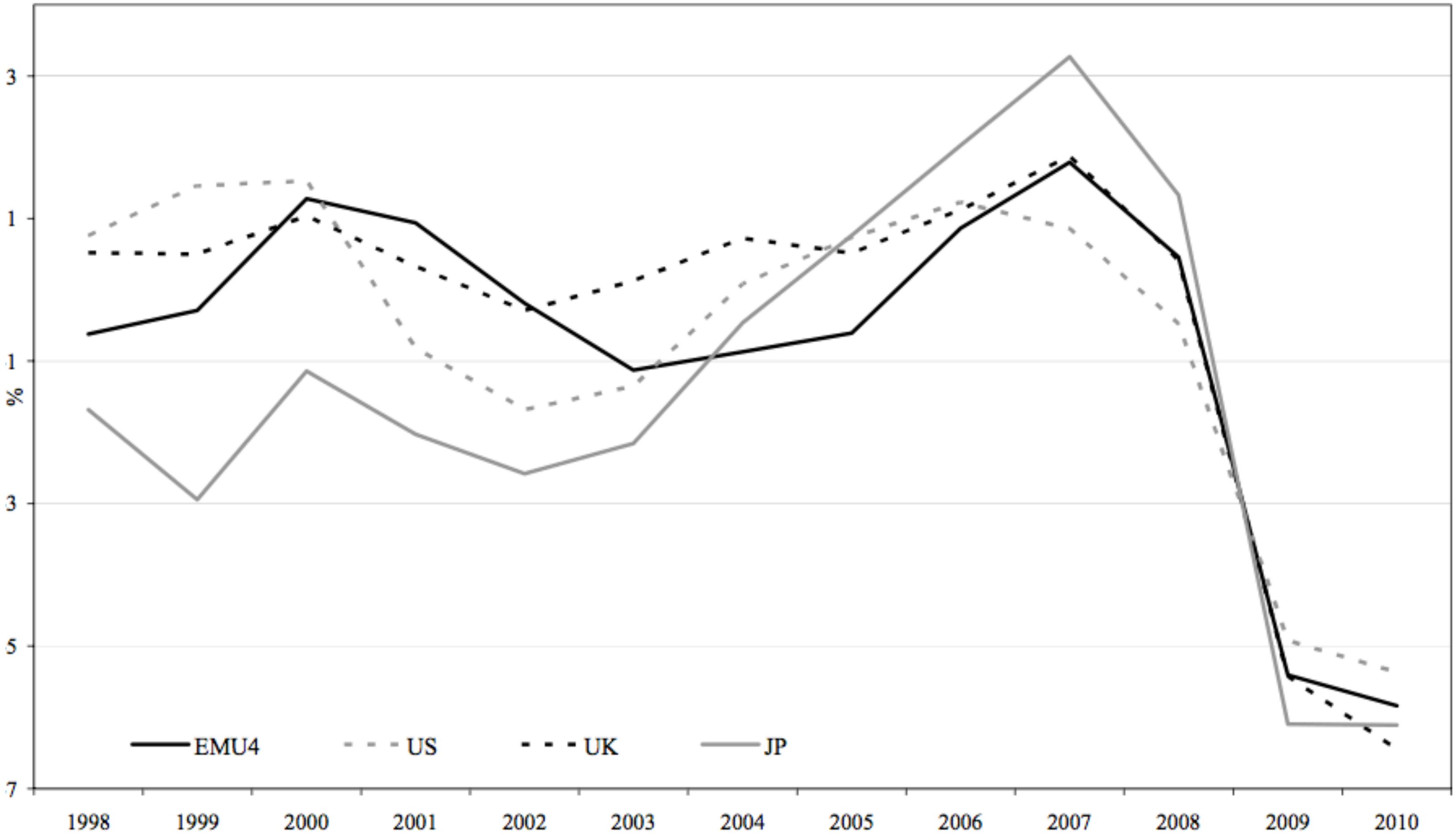
2. **who believe it's still before us**

2 camps are not looking at the same statistics, nor speaking same thing while using the same words.

Looking the change in flows and at the level of the stock of public debt.

Change in flows Is becoming positive almost everywhere.
Level of stock has grown to fairly high level which according to them legitimates the call for an exit strategy.

Focusing its attention on the levels of flow, at the stock of unemployed, at the poverty rate and at the wealth of Nations.



Source: OECD Economic Outlook. EMU4= Germany, France, Italy, Spain

Level of GDP of OECD countries is about 400 basic points lower from 2008.

Critical situation for:

1. world exports
2. unemployement
3. increased number of persons in absolute poverty

In what follows, we will take successively a global view , an European one and a French one. We will conclude by highlighting the situation of developing and emerging countries and the policies they should conduct with the help of the international community.

World economy from 2008 to 2009

Most severe recession in decades

-Subprime mortgages
-Derivative market

excessive losses

DISRUPTED THE FINANCIAL SECTOR

CONSEQUENCES:

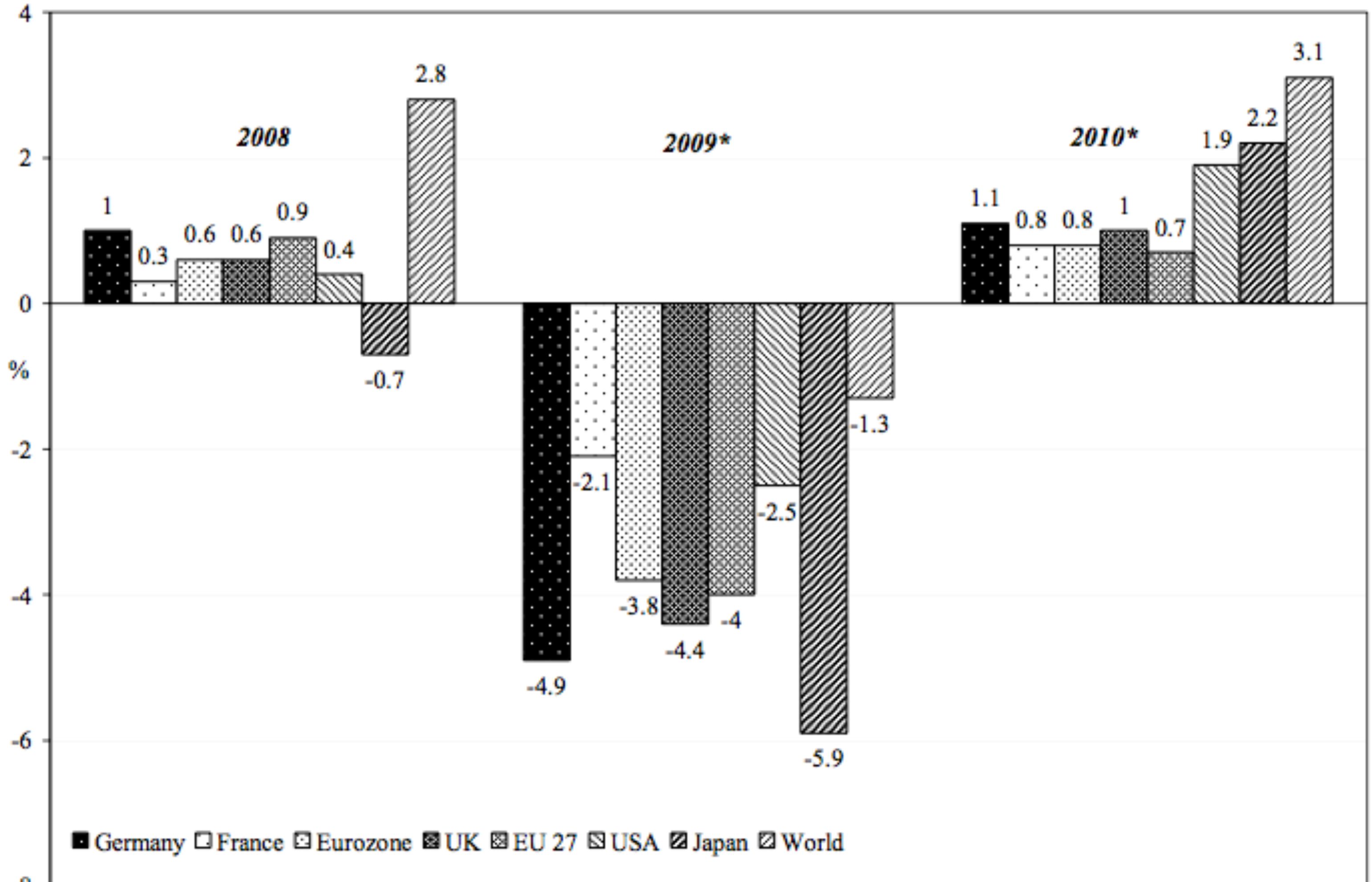
-severe tightening of credit conditions

-drastic fall in the value of financial assets

-through decreased trade and exports the crisis quickly spread from the US to other countries

-emerging countries not were unable to compensate for the crisis of developed countries (hit harder)

The Figure shows GDP growth figures and forecasts for 2009-2010 (OECD, (2009)).



Sources: IMF, OECD. *OFCE forecasts (October 2009)

- From the figure it can be noted:

-overall decrease in GDP in 2009 remains historically high

-european countries (except france) seem to be suffering more than US from the crisis

IMPORTANT: United States is considered as the epicenter of the crisis

Why the crisis hit harder Europe than the US?

First stage: Europe crisis would be less hit than the US. World market was simply localized in the US and all the financial actors mainly from the rich countries played on this market spreading the toxic assets all over the world. Europe banking sector proved to be as fragile as the american one.

CONSEQUENCES
(similar events to US)

-banking sector insolvence
-confidence crisis
-drying up of intrerbank mkt
-flying to safety and asset depreciation
-credit crunch
-drastic private spending reduction
-negative wealth effects

Difference between US and Europe:

The US fiscal and monetary policies were more reactive to the shock (in timing and size/only major difference that can be observed in the past twelve months)

A proactive macroeconomic policy is followed by US,(by republican and democrat administrations) is necessary for a system that made the political choice of minimizing social safety nets. US system is the result of a political and democratical CHOICE.

In a RESTRICTIVE macroeconomic policies with an important role of automatic stabilization the problem is: increasing emphasis on structural reforms and on the necessity of downsizing the welfare state.

SARACENO show how the role of automatic stabilization and of social protection has been constantly decreasing over time BOTH in the US and EU, but only in the latter the role of macroeconomic policy has been proactive, as would have been consistent with this trend. This fundamental inconsistency is in the Fitoussi/Saraceno opinion at the roots of the poor macroeconomic performance of the EU, when they compare it with the US.

Monetary policy and the subprime crisis

Subprime mortgages = heart of a chain of financial innovations

Multiplied the effects of the initial shock.

When the housing market slowed down, mortgages that would be viable only because the price of the collateral they were based upon was increasing, became "**toxic**" . Risks turned out to be correlated, and their scattering through securization, instead of being a source of safety, was the vehicle for spreading the infection to the whole system.

AUGUST 2007: Central banks inject liquidity in the system to try to safe it.

Monetary policy and the subprime crisis

Crisis quickly evolved in a vicious of deleveraging:

- Bank tried to sell their assets in order to buy safe debt
- The subprime crisis represents a typical case in which solvency and liquidity problems are difficult to disentangle.

the crisis hitted the credit sector with no regard to actual solvability of the individual institutions, dramatically increasing the systemic risk

Strategy of BCE: priority to price stability

controlling interest rate (for the inflation)

June 2007 to july 2008 = 4% → increase because there's an increase of the cost of energy.

DEFLATION

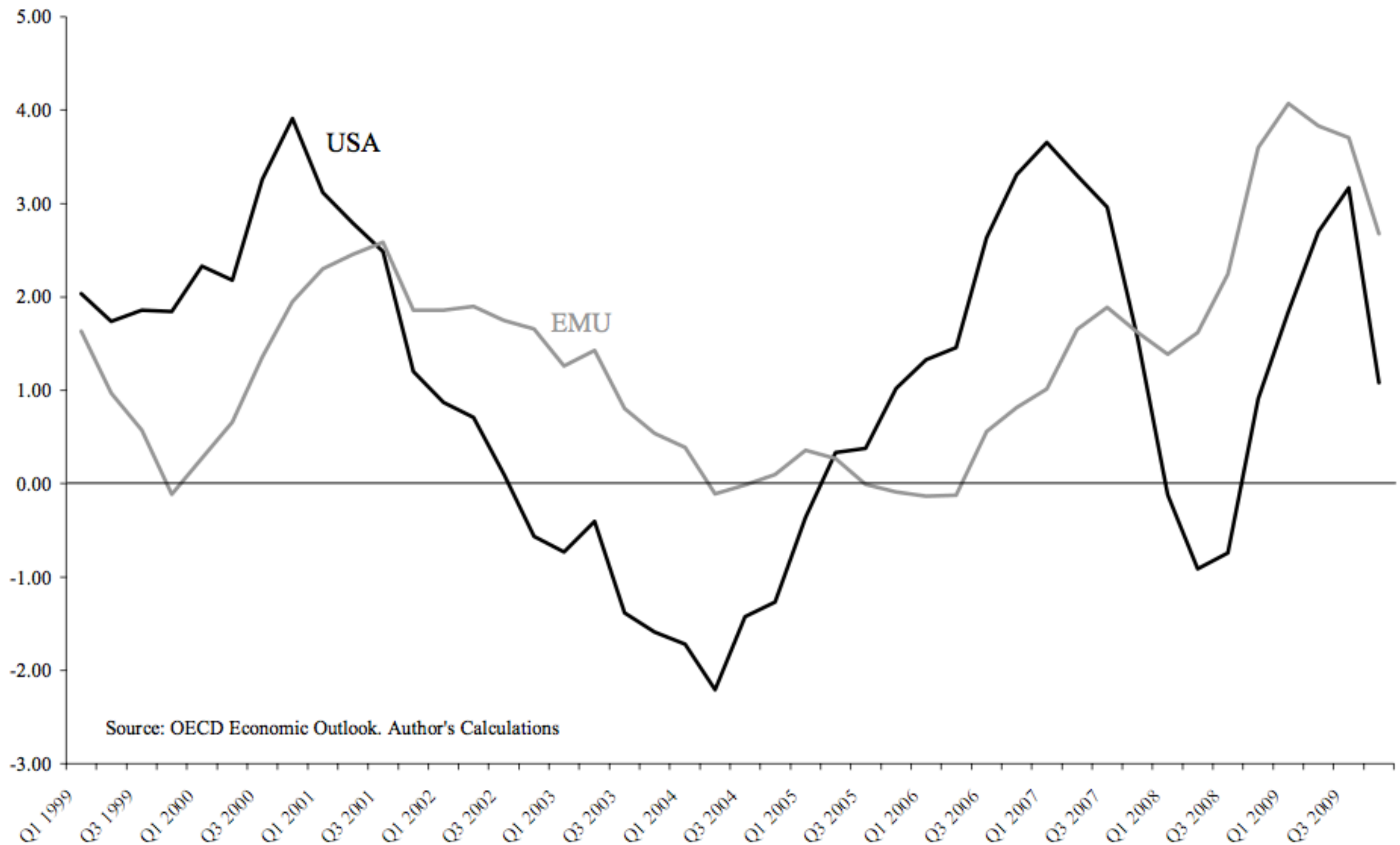
Monetary policy and the subprime crisis

May 2009 = BCE began a series of rate decreases, brought the marginal lending facility rate at their current level of 1.75.

Initially solution with through short term refinancing operations which provided the very short term liquidity that the system needed, without nevertheless increasing the long term amount of money.

UNITED STATES strategy: The strategy pursued by the Fed was rather different. At least in an initial phase, the US central bank used the interest rate instrument to curb the interbank rates (LIBOR), and to inject liquidity into the system. The first reaction of the Fed was a reduction of the Primary Discount Rate, in order to narrow the band for short rates (The ECB did the same thing only in October 2008, for the 4 months to January 2009). Subsequently, the Fed cut all rates in five different occasions, keeping the window constant. Overall, Fed Funds target rates went down 225 points in 4 months, and were further lowered in the fall 2008 to the current level of 0.25% (the discount rate being 0.5%). Furthermore, central banks have increased their exposure, by engaging in longer term loans to the banking sector. Hence one of the common features to central banks reaction has been to hugely increase their quasi-fiscal operations without entering into formal agreement with the treasuries.

Spread between short term rates and the Taylor Rule



Taylor rule

$$i = \hat{\imath} + \alpha\,(\pi - \hat{\pi}) + \beta\left(\frac{Y - \hat{Y}}{Y}\right)$$

If inflation rises by one percentage point, BCE must increase the nominal interest rate more than one percentage point.

Fiscal policy

- In this part the authors, dealing with fiscal policy explain the situation of the "LIQUIDITY TRAP" in which private savings have to go into government securities.

To transform these savings in demand, to curtail deflationary expectation, to restore the value of assets and to escape deflationary process.

- The most important element of an effective stimulus package are the public investment, the sustaining of the income and the capacity to spend of the owners, blue collar workers and the ability of avoiding new workforces.

- All esitimates indicate the need of a fiscal stimulus of around 2% of GDP, but it’s very difficult to give a quantitative assessment of the needed stimulus, and this is caused by the continued revisions of policies and forecasts by national governments.

- Today, infact, only a few institutions have multi country models and use them for policy analysis and forecasting.

- The authors underline that the dismissal in the past of these multi country models was a mistake that we are paying today.

- It is of FOREMOST IMPORTANCE that the international community helps some countries that may not be in the position to afford a fiscal stimulus of several points of GDP, to carry out the needed measures exactly as it needs to help them with the banking rescue package. Another important aspect is the sustainability: it is essential to observe concerns about the long term sustainability of current action.

- If the economy will enter in an expansion phase, we'll have to remember that fiscal policy should turn restrictive as soon as possible; turning to budgetary restrictions is very dangerous, because it could undermine all the previous effort to sustain growth.

- The COMPOSITON OF SPENDING as a regards sustainability is another main point because of the growth potential of economy and hence future growth.

- The authors speaks of European governments' answer to the crisis and say that it is significantly LESS AGRESSIVE in the US and even in Japan: we can conclude that macroeconomic police has been far more inertial in the EU than in the USA seeing the comparatively less expansionary stance of the ECB, with respect to the FED.

- Thanks to the works of the authors, we can be sure of the fact that monetary policy has been less reactive than in the US and fiscal policy in the past has not been as responsive to the cycle as it should have been.

WHAT HELPED FRANCE SMOOTH THE IMPACT OF THE CRISIS?

- France seems to have been able to fight the crisis better than its partners, it looks more resilient than its large euro zone partner also if we look at industrial production. Why?

2 MAIN FACTORS:

1. the first one is the relative strength of automatic stabilisation, that has more than compensated the timidity of the discretionary stimulus, thus providing the overall support to aggregate demand.

2. The second element is more structural: the authors observe that, according to the most measures, the trend of mounting inequality has been less pronounced in France than in other countries.

LESSONS FOR DEVELOPING COUNTRIES

- These countries suffered from the drying of financial markets and from generalized drop of confidence of foreign investors, as well as from a steep reduction of demand for their exports; there are also increasing risks of being negatively impacted by more or less explicit protectionist policies that are currently surfacing in developed countries.

- All these factors concur to the disruption of the economy of the low-income counties: the private sector is, in these countries, often unable to cushion the shocks, with long lasting effects on malnutrition, school attendance and the insufficiency of well functioning welfare systems.

- In the final part of the work the authors deal with the conclusions of this work:

1. first of all infrastructure investment, social spending in the areas of nutrition, basic education and health should be focus of fiscal policies in developing countries. It is very important that increasing resources devoted to rescue packages should not be done through reductions of ordinary aid funds, that should increased as much as possible.

2. The second lesson for the developing countries is that policies should be implemented to reverse the trend in distribution. Contribute to sustain aggregate demand in medium-long run is also very important.

To reach this conditions countries may adopt measures aimed at increasing the progressiveness of the tax system, redesign the welfare system and aimed it at redistribution and human capital formation.