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Growth Policy Lessons from the Great Recession

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How it all happened (like in most financial crisis, of course)

- **US:** Private debt and derivative finance had grown fast in the first half of 2000s. Speculative bubbles in housing and financial markets. Problems triggered by subprime loans in 2007.
- **Europe:** The crisis spread out and affected European banks (IKB in Germany, BNP in France, Northern Rock in the UK).
- **Central banks:** Initial (weak) reaction by the FED and the ECB.
- **US:** Fannie Mae and Freddie Mac rescued; bankruptcy of Lehman Brothers; the Black Monday at NYSE (Sept 15, 2008).
- **Europe:** Fortis, Dexia, Hypo, Bradford&Bingley, etc. rescued.

Financial crisis getting real

- **Financial crisis** turned into a big recession (… as usual).
- **Trade channel:** About 20% drop in global trade. Between 1Q08 and 2Q09 export-oriented economies were hit harder, i.e. GDP at -6.8% in Germany, -7.2% in Italy, -9.2% in Japan. It fell 4.3% in the US, 5.2% in OECD countries and 5.6% in the Euro Area.
- **Financial and confidence channels:** liquidity squeeze for households and companies; collapse in business and consumer confidence impinging on investment/consumption.

Italy: the strong points

- Initially only minor effects on the **banking system** (less toxic assets, less bad loans, a more traditional banking model).
- **No housing bubble, less household debt**.
- **Financial wealth** of households (including pension funds) less exposed to stock market gyrations.
- Funding of business investment less dependent on financial markets.
- **No major macro imbalances**, including the external position and leaving aside government debt.

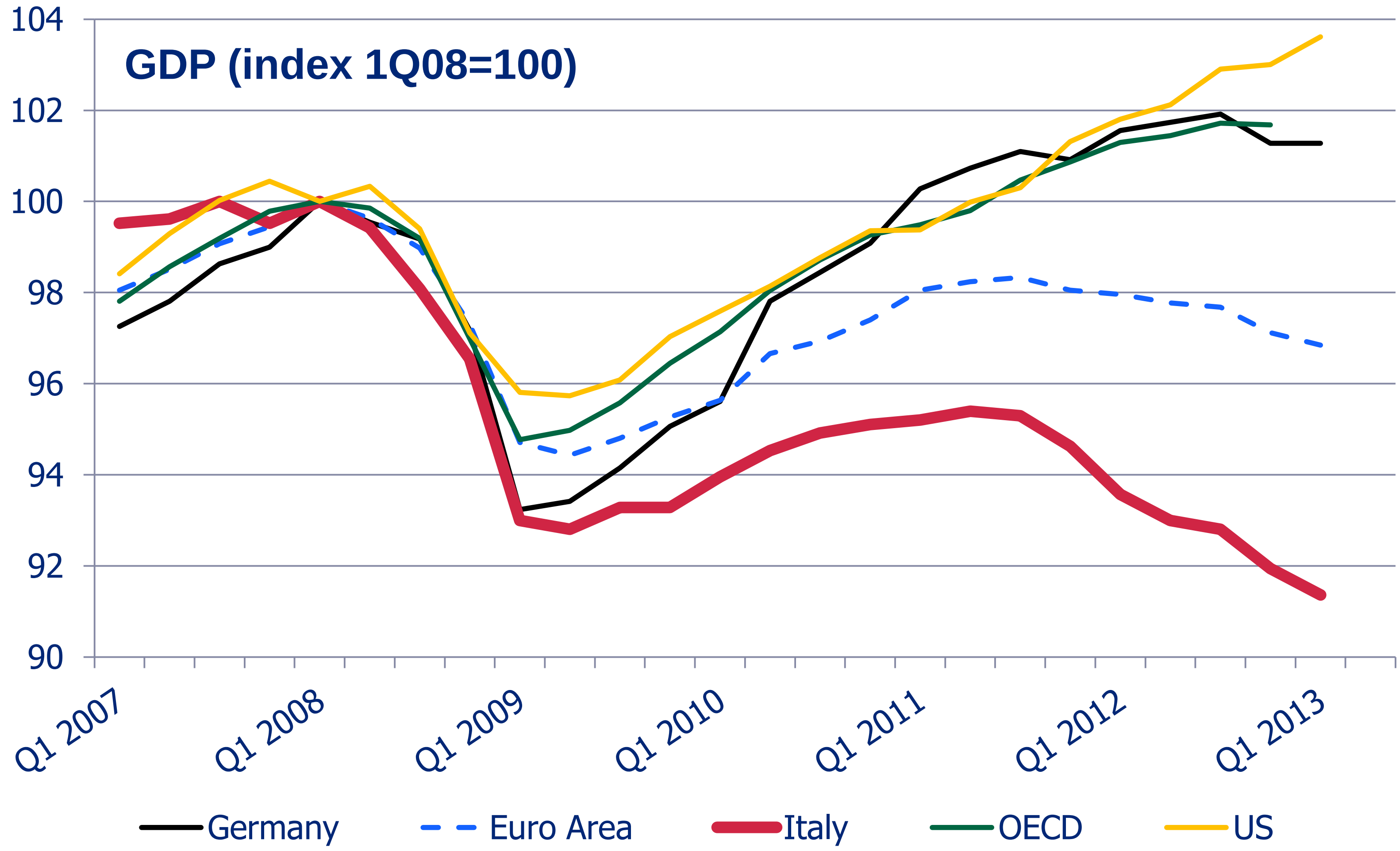
Italy: the weak points

- Structural weaknesses neglected for years. The crisis hit a country with **little resilience to shocks,** already showing a protracted downward trend in potential growth.
- Large sectors of the economy **not exposed to competition and not efficient**. Growth-enhancing reforms **not fully implemented or not significant enough**.
- **High public debt** made Italy vulnerable to financial shocks and reduced the leeway for discretionary fiscal policies.
- **A sticky labour market** made for adjustment mainly coming from unemployment rather than wages.

Italy: the weak points

- **Product markets** were also not very reactive, i.e. not capable to quickly adjust to shocks.
- **Industrial structure** was (and of course still is) characterised by a large number of SMEs, some 70% family owned, financed by commercial banks, less export-oriented, mostly specialised in traditional manufacturing, with low R&D investment.
- **The crisis called for long-awaited structural adjustments, fiscal consolidation on the spending side combined with a rise in public investment and the full working of automatic stabilisers (with ultra easy monetary policy).**

Falling together and recovering apart



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The world recovery and the European double dip

- Between 2Q09 and 1Q11 **global trade improved and GDP recovered its pre-crisis levels** in the US, Germany and the OECD average; much slower pace in the Euro Area and especially in the European ‘periphery’.
- Measures undertaken by governments and central banks were initially **successful** in restoring confidence in financial markets and sustaining aggregate demand.
- Doubts on the **sustainability of public debt**, especially in Greece and Portugal (and then Spain, Ireland and Italy) leading to a diversified approach to fiscal consolidation and a credit crunch.

The debate on austerity policies

- The mainstream approach: **very accommodative monetary policy combined with fiscal consolidation**.
- **Ricardian equivalence**: no stimulus to the economy by deficit spending since fiscal stimulus simply crowds out private demand in the long run (Barro 1976).
- **Rogoff and Reihnart (2010)**: growth slows down when public debt goes beyond some threshold (90% of GDP), confirmed by several empirical studies (e.g. Egert 2012) even though the direction of causality is not clear.

The debate on fiscal multipliers

- Mainstream approach criticised (Greece): **austerity policies** may worsened both the recession and public debt sustainability.
- **Blanchard e Leigh (2013):** fiscal multipliers underestimated. Thus austerity policy are likely to be mostly counterproductive.
- **Christiano, Eichenbaum e Rebelo (2011):** fiscal multipliers could be very large (up to 3.5) during a recession if central banks cannot cut interest rates below zero.
- **Alesina, Favero and Giavazzi (2012):** fiscal multipliers are strongly asymmetric; adjustments based upon spending cuts results in smaller output losses than tax-based ones.

Any lesson after such a big mess?

- High public expenditure and debt likely affect most long-run **drivers of economic growth**, i.e.: technology, demography, saving propensity, human and physical capital accumulation.
- But there are exceptions …
- Deficit spending (and related debt) may be **growth enhancing** if it funds investment in high productive human capital, infrastructures, R&D, etc..
- Deficit spending may support growth if **austerity-induced recession** brings a permanent (and not recoverable) loss of human capital (as pointed out by most new Keynesians).

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Any lesson after such a big mess?

- High public debt implies **future transfer of resources** from (poor) tax payers to (rich) govies holders and **resource outflows** if public debt is held by foreign investors.
- **Reinhart and Rogoff** in their 2010 book (much more insightful than their notorious paper) and Kindelberger some 40 years earlier, argue that economic crises **are more similar than economists are willing to admit.**
- At the root of the recent crisis (and many others) are **macroeconomic imbalances**: there is a need to closely monitor them to prevent future crisis.

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Any lesson after such a big mess?

- Crises start with some ‘bubbles’ (from tulip bulbs to subprimes) and end with a dramatic GDP adjustment. People were too confident on the soundness of some assets before the crises and too frightened and cautious later: **first lesson (not) learnt is that asset prices should be carefully monitored before any bubble emerges.**
- Governments and central banks should be (or pretend to be) willing to do “whatever it takes” to **restore confidence**.
- In any crisis, there is huge income redistribution: **need to preserve social cohesion to avoid political crisis.**