



The Global Crisis: Its Development and First Policy Lessons

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*OECD ANNUAL MEETING WITH THE
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OF THE NATO PARLIAMENTARY ASSEMBLY*

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Outline

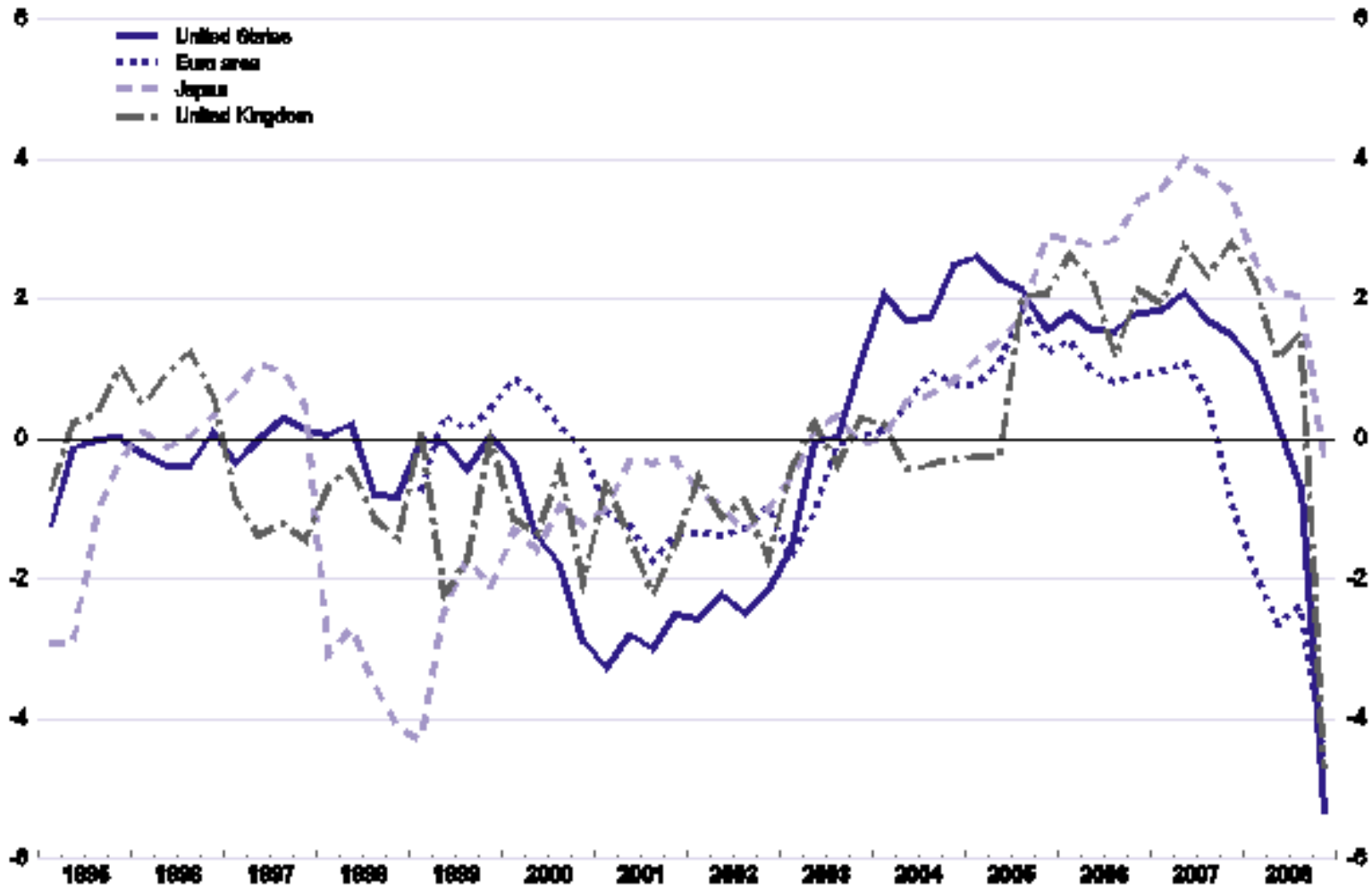
1. Global Financial Crisis
2. Global Recession
3. Crisis Management in Financial Markets and Macro Policies
4. Exit Strategies: Addressing Financial and Macro Policy Challenges

Causes and Origins

- Unrivalled in depth, market spreading and global spreading.
- Triggered by dislocation in the US sub-prime market ...
- ... but fundamental cause is excess credit growth ...
- ... driven by a complex combination of regulatory, market, and policy failures ...
- ... compounded by a massive loss of market confidence ...
- ... and the speed and depth of the real-economy downturn
- ... accentuated through trade and financial globalisation.

Massive Deterioration in Financial Conditions

(OECD index measuring the impact of financial conditions on GDP *)



•Source: OECD Economic Outlook 84 database; Datastream; and OECD calculations.

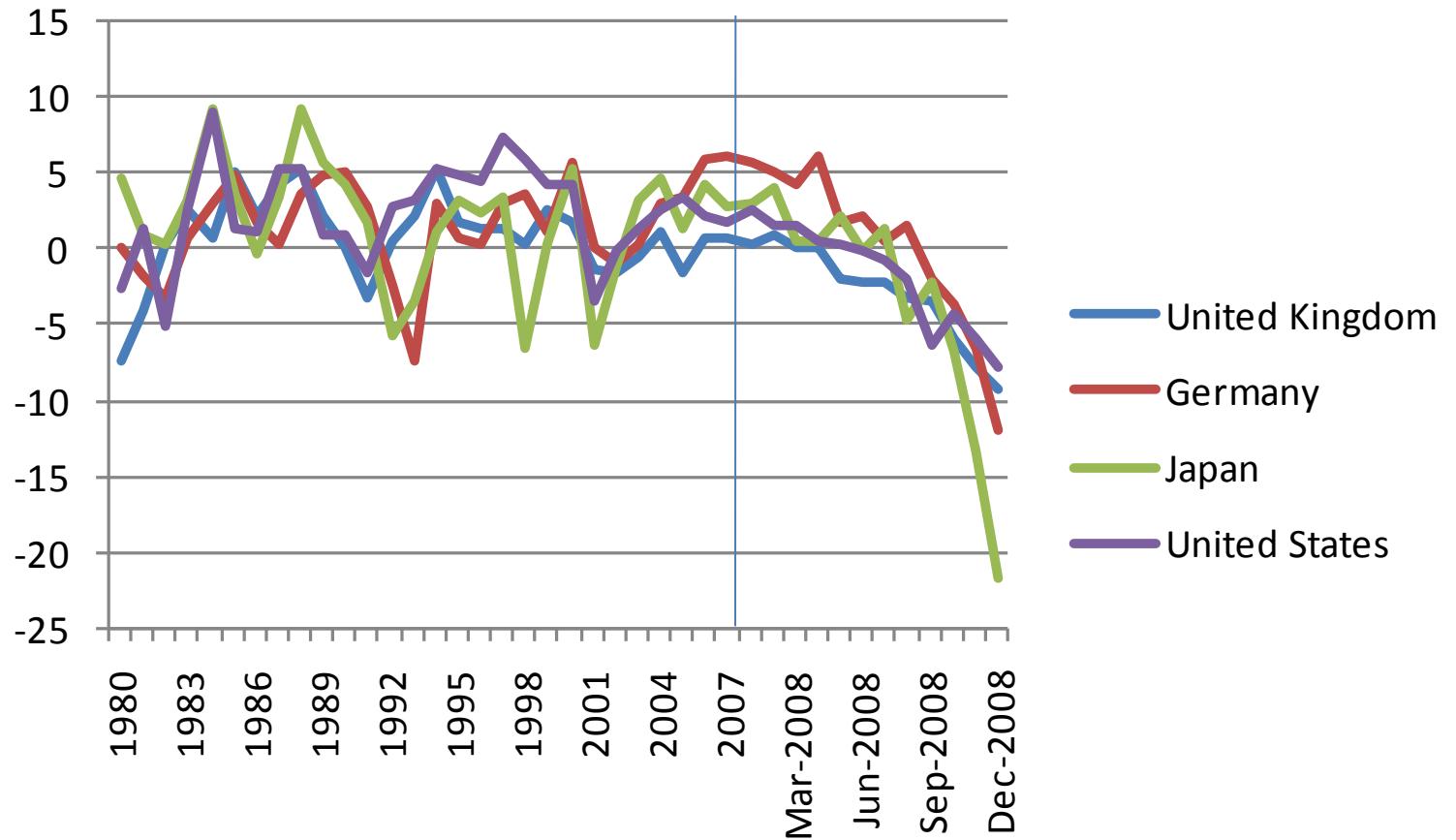
•* A unit increase in the index correspond to an effect on GDP equivalent to an increase in real long-term interest rates of 1 percentage point.

Global Recession

- World recession is also historically unprecedented in scale, depth, market spreading, and global propagation and synchronicity
- Recession depth and synchronicity due to:
 - 1) Epicentre is in the U.S.
 - 2) Initial conditions: overheated world economy and overheated asset and commodity markets;
 - 3) World financial crisis – massive financial meltdown
 - 4) Large world trade and financial integration

Global Recession

(Industrial production growth %)



Crisis Management

Policy responses have been swift and massive in three areas:

- 1) Large-scale financial sector interventions
- 2) Massive monetary policy easing
- 3) Large fiscal stimulus plans

Financial Sector Interventions in OECD Countries

	Traditional monetary instruments				Crisis resolution instruments				
	Liquidity injections	Interest rate changes	Increased guarantee of private deposits	Guarantees for bank loans or debt	Funds to purchase commercial papers	Purchase mortgage bonds	Ban or restrict short-selling	Capital injections ¹	Option to purchase toxic assets
United States	x	cut	x	x	x	x	x	x	x
Japan	x	cut		x	x		x		
Euro area	x	cut	x						
Germany			x	x			x	x	X
France			already high	x			x	x	
Italy			x				x	x	
United Kingdom	x	cut	x	x	x	x	x	x	
Canada	x	cut		x		x	x		
Australia	x	cut	x	x		x	x		
Austria			x	x			x	x	
Belgium			x	x			x	x	
Czech Republic		cut							
Denmark	x	increase /cut	x	x		x	x		
Finland			x	x	x		x	x	
Greece			x	x				x	
Hungary	x	increase	x	x				x	
Iceland		increase	x				..	x	
Ireland			x	x				x	
Korea	x	cut		x					
Luxembourg			x	x					
Netherlands			x	x			x	x	
New Zealand	x	cut	x	x					
Norway	x	cut	already high	x					
Slovak Republic		cut	x						
Poland	x		x						
Portugal			x	x				x	
Sweden	x	cut	x	x		x		x	
Spain			x	x		x	x		
Mexico	x			x					
Switzerland	x	cut	x		x			(x)	X
Turkey	x	cut							

- Massive conventional monetary easing accelerated in recent months
- Several major economies have reached zero policy rates – and many more are likely to reach the neighbourhood of zero rates in the near future
- Current conditions of extreme financial stress have weakened effects of interest rate cuts ...
- ... justifying adoption of complementary unconventional forms of quantitative monetary and credit easing, as well as asset acquisitions in illiquid markets.

Desirable Features of Fiscal Stimulus Plans

- Timely, temporary, targeted
- Size determined by:
 - Economic conjuncture
 - Initial fiscal balance and debt levels
 - Size of automatic stabilizers
- Targeting: short-term (stabilization); long-term (growth); job creation; equity; green recovery – there are win-win measures
- Supported by strong, credible, and up-front commitment to medium-term fiscal sustainability.

- Size: fiscal stimulus programs in OECD average 3 % of GDP, ranging from 0.1% for Switzerland to 6.0 % for the US
- Timing: frontloaded in 2009, lower commitments in 2010-11
- Targeting: tax cuts are the main component followed by government investment
- Sustainability: some countries (for example Germany, UK and Finland) have also announced future consolidation measures

Compositions of Fiscal Plans

	Spending Expansion				Tax Cuts			
	Gov. Cons +Inv	Transfers households	Transfers business	Others	Individuals	Business	Consumption	Contributions
Australia	X	X			X	X		
Austria	X	X			X	X	X	
Canada	X	X	X	X	X	X	X	X
Finland	X	X	X	X	X	X	X	X
Germany	X	X	X	X	X	X	X	X
Japan	X	X	X	X	X	X	X	X
Korea	X	X	X	X	X	X	X	
Spain	X	X	X		X	X	X	
Sweden	X	X			X	X		X
Switzerland	X				X		-	
United Kingdom	X	X				X	X	

Moving From Crisis Management to an Exit Strategy

- Many emergency measures taken add to future moral hazard...
- Many fiscal stimulus plans pose risks for long term sustainability...
- Monetary easing may risk a future inflation surge ...
- ... if not credibly correctly or withdrawn
- Need to plan for withdrawal now, but only act when state of the world is different
- Implementing exit strategies too early may harm public confidence

Addressing Financial Market Failures

- Lack of transparency of private-sector financial instruments, transactions, and balance sheets
- Agency problems (bad incentives) in financial firms
- Inadequacy of risk management (bad risk assessment models, bad management practice)
- Wrong incentives in risk rating industry
- Overcoming “too big to fail”: imposing divestiture requirements in financial markets?

Addressing Financial Policy Failures

- Inadequate capital requirements for banks: excessively low and pro-cyclical (macro prudential regulation needed)
- Lack of regulation and supervision of bank conduits
- Integrated regulation and supervision of financial and capital markets ?
- Revamping deposit insurance schemes
- International adoption and enforcement of common (basic) regulation and supervision of financial and capital markets

Addressing Monetary Policy Failures

- Merits a hard look: monetary policy could *lean against the wind*, reacting to asset price misalignments over and above the reaction to fixed-horizon inflation-forecast targeting
- Central banks may need to respond to asset price and credit booms

Design Resilience-enhancing Fiscal Policies

- Necessity to implement (or strengthen) a framework of counter-cyclical discretionary fiscal policy
- Increase effectiveness of automatic stabilizers
- Fiscal measures consistent with long-term objectives
- Contingency planning:
 - Think through and adopt well in advance a set of coherent financial-fiscal-monetary contingency measures to be adopted in times of systemic financial crises and deep recessions.



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