


Economic vulnerability to macroeconomic shocks: the role of policies and institutions

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Introduction

- Vulnerability of societies is their vulnerability to unforeseen shocks (e.g. earthquake, H1-N1, OPEC oil supply cut, broad-based reassessment of financial risks...)
- Vulnerability depends on: 1) *ex-ante* probability of shocks; 2) *ex-post* impact of shocks once they occur
- *Ex-ante* probability of shocks depends in part on policy factors: e.g. link between weak pre-crisis prudential regulation and magnitude of subsequent banking sector shock, possible role of loose monetary policy in 1st half of 2000s... 
- ...but also on factors that are out of government control, e.g. country size, geographic conditions


Introduction (cont.)

- Given breadth of topic, focus of this talk is on:
 - *Ex-post* impact of shocks, *i.e.* on minimising their damage rather than preventing them altogether
 - *Economic* vulnerability: no discussion of other dimensions, *e.g.* personal insecurity and crime
 - *Income and employment* vulnerability: no discussion of other dimensions of economic vulnerability, *e.g.* risks associated with illness or old-age
 - *Addressing*, not measuring vulnerability (daunting challenges in measurement include aggregating different vulnerability dimensions, and for each of them weighing different population groups)

Introduction (cont.)



- There are 3 main dimensions to minimising income and employment damage from shocks:
 1. Macro resilience of the economy, *i.e.* its ability to minimise overall income and job losses from shocks
 2. How cost of shocks is spread throughout society, *i.e.* whether pre-shock risk-sharing arrangements ensure efficient and equitable distribution of costs *ex-post* (e.g. recent failure of *de facto* arrangements for sharing risk of banking sector going bankrupt)
 3. Whether risk-sharing arrangements are achieved at least cost (unconditional minimisation of risk is *not* desirable: risk aversion is finite, insurance is costly)

1. Macroeconomic resilience to shocks


- Resilience to shocks depends on two factors:
 - The impact effect of the shock, *i.e.* the *mitigation* dimension
 - The subsequent speed of return of output to its long-term level, *i.e.* the *resorption* dimension.
- OECD empirical analysis of GDP dynamics points to significant cross-country differences along both dimensions over past 25 years (Duval-Vogel 2008):
Two small, light blue square icons, each containing a white upward-pointing arrow, positioned to the right of the text.

Mitigation of common shocks stronger in continental Europe, but resorption faster in English-speaking countries, with some Nordics good on both criteria

1. Macroeconomic resilience to shocks

- These cross-country differences appear to relate in part to labour/product market institutions:
 - Indicators of labour/product market regulation have offsetting effects on shocks mitigation & persistence 
 - Rationale: stringent EPL and PMR dampen initial lay-offs, but they reduce wage/price flexibility, delay adjustment and slow down recovery...
 - ...including by inducing less aggressive monetary policy responses to shocks (e.g. Fed/BoE vs. ECB)
 - Fiscal policy management also matters: continental Europe < English-speaking countries and Nordics 

1. Macroeconomic resilience to shocks

- To sum up: positive impact of counter-cyclical monetary/fiscal policies on resilience, ambiguous impact of labour/product market institutions
- Net impact of labour/product market “rigidities” nevertheless found to be detrimental, based on simple resilience criterion = cumulative output loss in aftermath of shocks 
- If correct, smaller impact effect of recent crisis in a number of continental European countries may be followed by slower recovery, compared with English-speaking countries and some Nordics (*ceteris paribus*)

2. Least-cost sharing of economic risks

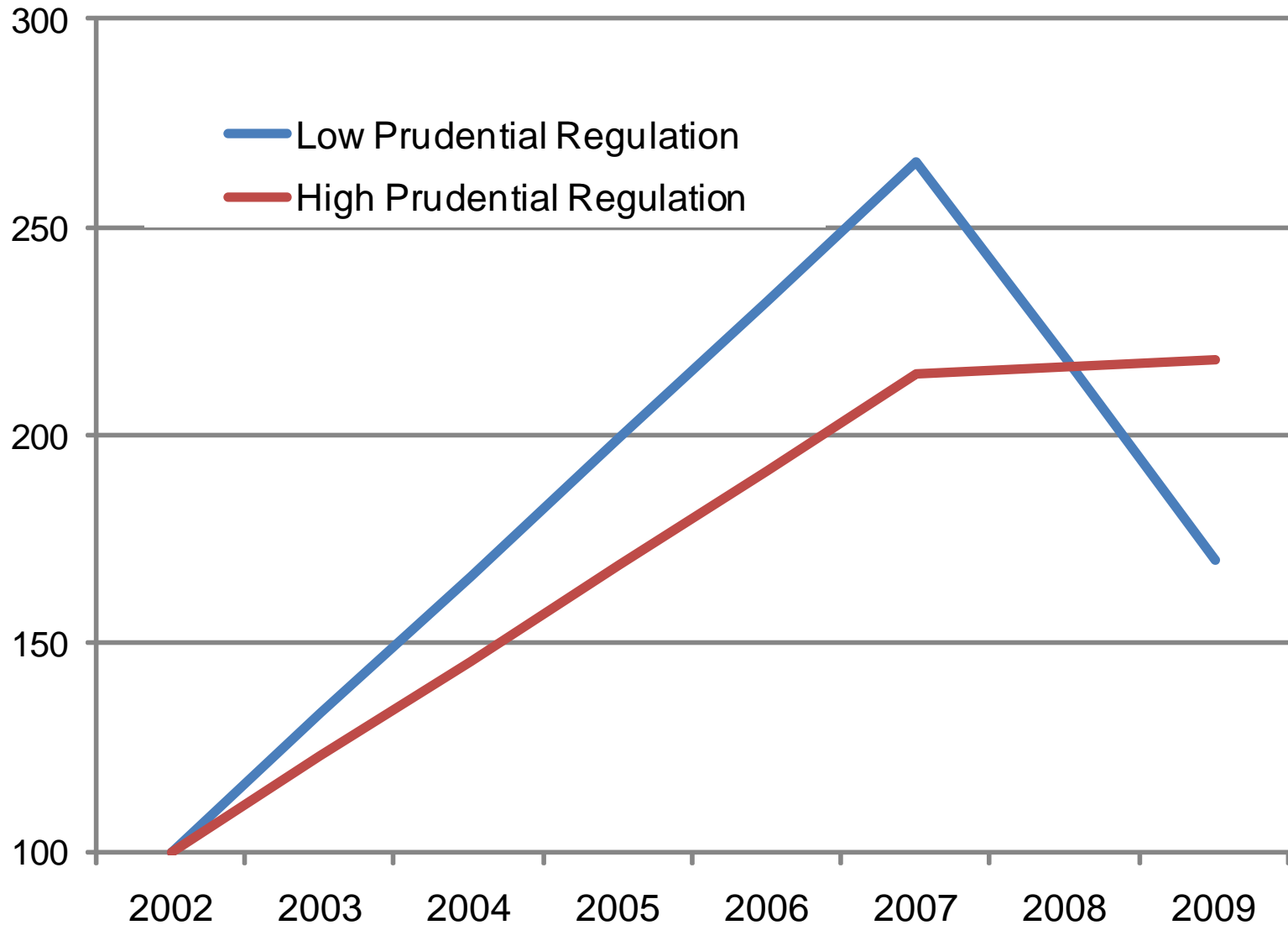
- Labour/product market institutions shape economic vulnerability through macro resilience, but also by determining how risks are spread across individuals
 - ➔ They have useful role to play as insurance and redistributive devices (e.g. UBs & social assistance)
- Main policy issue is thus to design institutions that:
 - have good insurance and redistributive properties...
 - ...but *do not* undermine macro resilience and are cost-effective (*i.e.* insure at least cost)

2. Least-cost sharing of economic risks

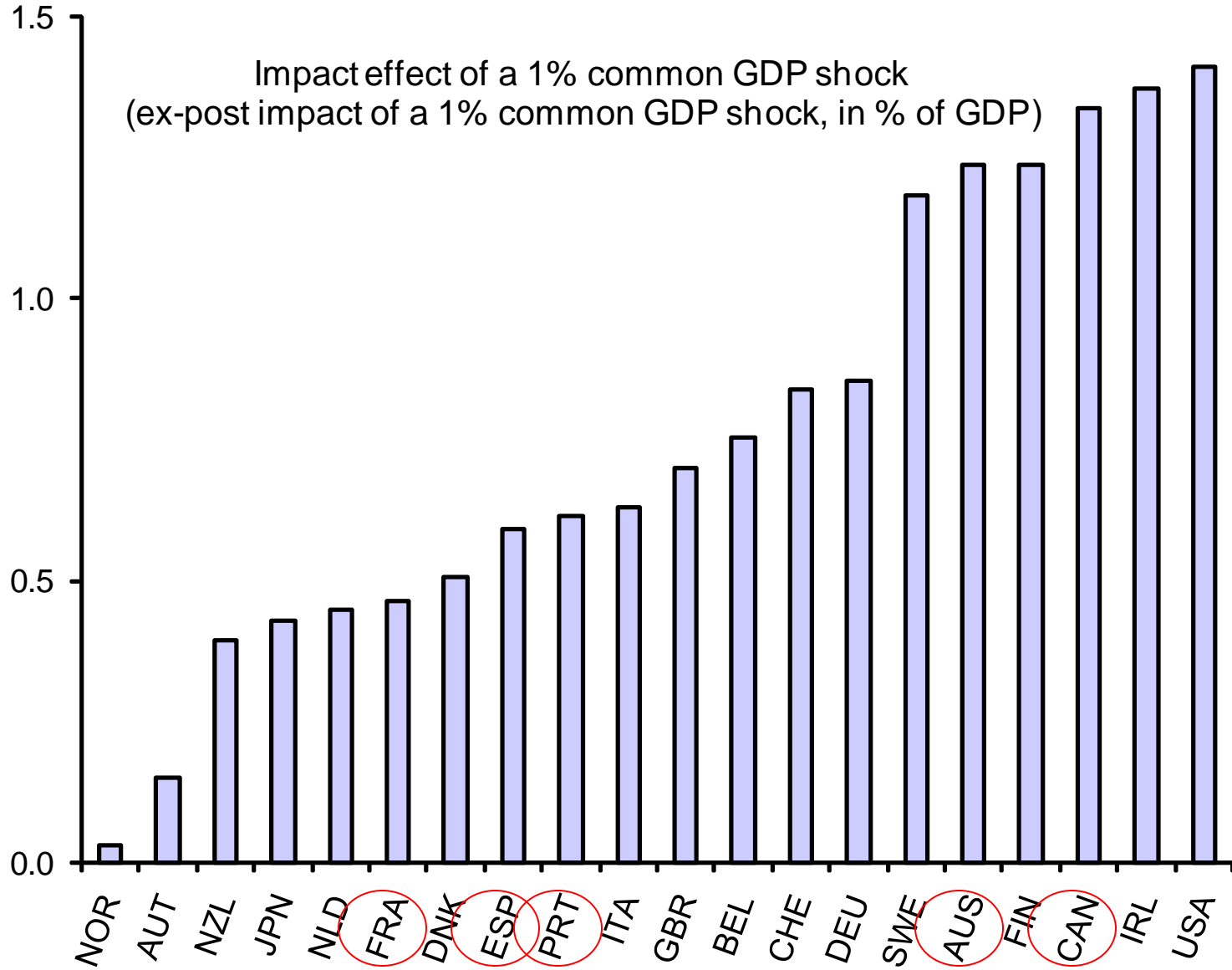
- Examples of arrangements that minimise trade-offs:
 - Macro policies: fiscal policy frameworks that ensure both counter-cyclicality and sustainability
 - Labour markets: back non-employment income support by job search requirements and financial incentives; protect workers not jobs, *e.g.* prefer UBs and ALMPs to stringent regular EPL (*i.e.* Nordic “model” # continental & mediterranean “models”)
 - Product markets: lower entry barriers (*e.g.* retail trade, liberal professions...etc), since few insurance & equity considerations involved (*i.e.* Nordics and English-speaking # continentals or mediterraneans)

THANK YOU

Simulated bank share prices over 2002-2009, "strictly" and "loosely" regulated banks (index 2002 = 100)



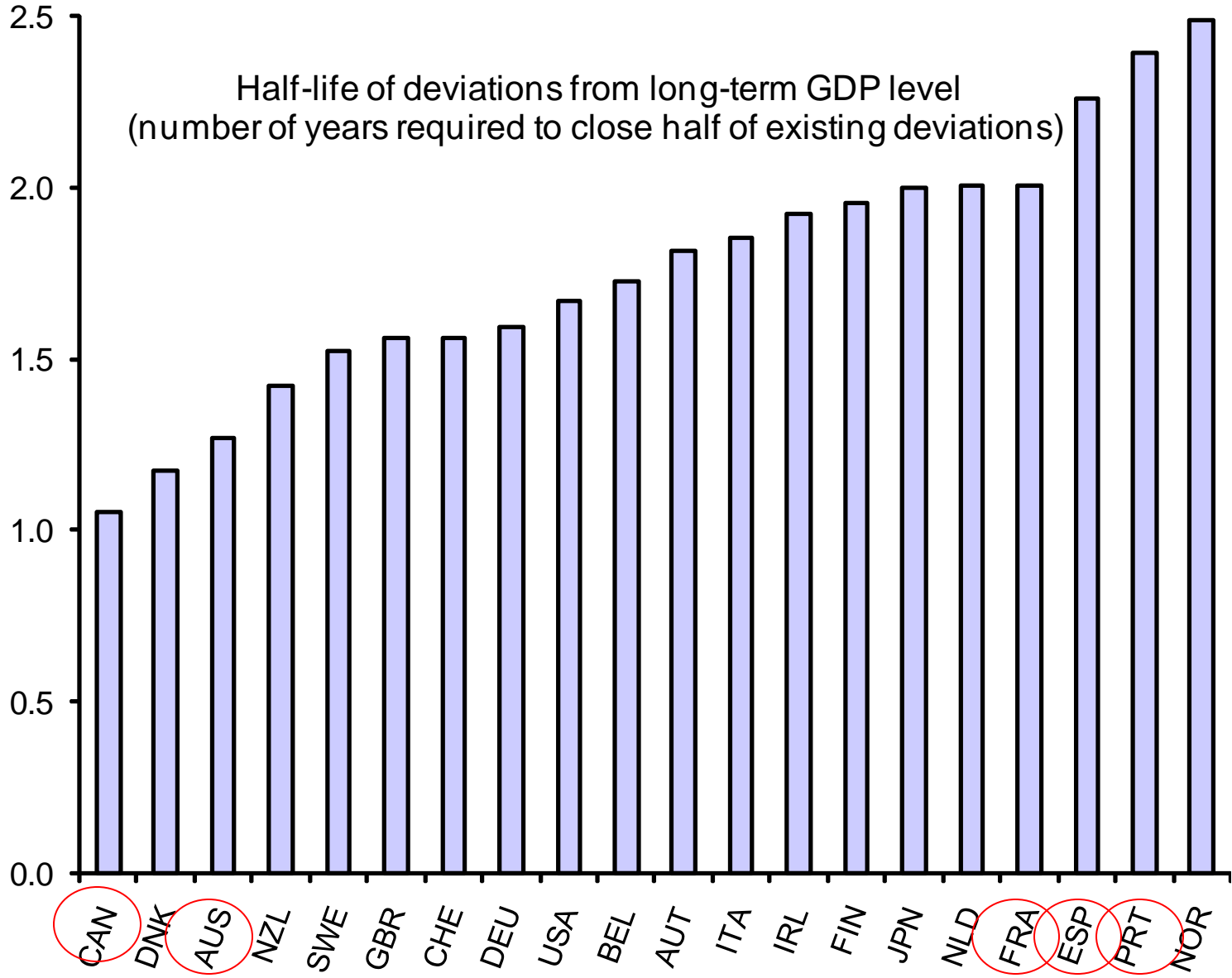
Estimated degree of mitigation of the impact of common shocks



Source : Duval R. and L. Vogel, OECD Economic Studies No. 44, 2008.



Estimated degree of persistence of the impact of common shocks



Source : Duval R. and L. Vogel, OECD Economic Studies No. 44, 2008.



Labour and product market policies correlate with opposite signs with (estimated) indicators of mitigation and persistence of shocks

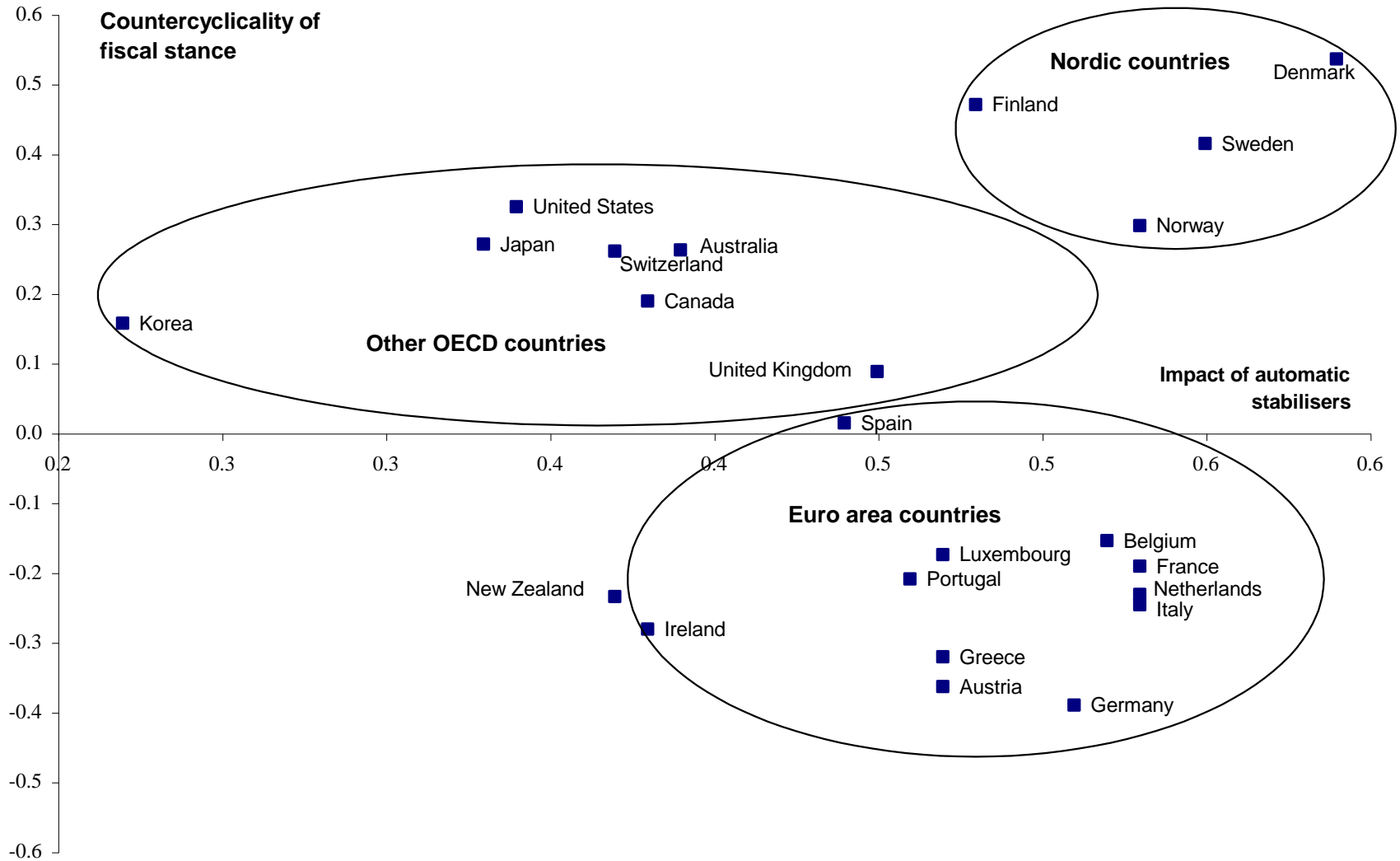
(Correlation coefficients across 20 country observations, see Duval-Vogel 2008 for details)

	Mitigation of initial GDP impact of shocks	Persistence of GDP impact of shocks
Average unemployment benefit replacement rate	0.39*	0.12
Stringency of employment protection legislation	0.43**	0.62***
Stringency of product market regulation	0.46**	0.58***
High corporatism of wage bargaining	0.54***	0.52***
Share of workers covered by collective agreement	0.23	0.29
Labour and product market regulation (synthetic indicator)	0.51**	0.5**

* significant at 10%; ** significant at 5%; *** significant at 1%.

Source : Duval R. and L. Vogel, OECD Economic Studies No. 44, 2008.

Automatic stabilisers and countercyclicality of discretionary fiscal policy

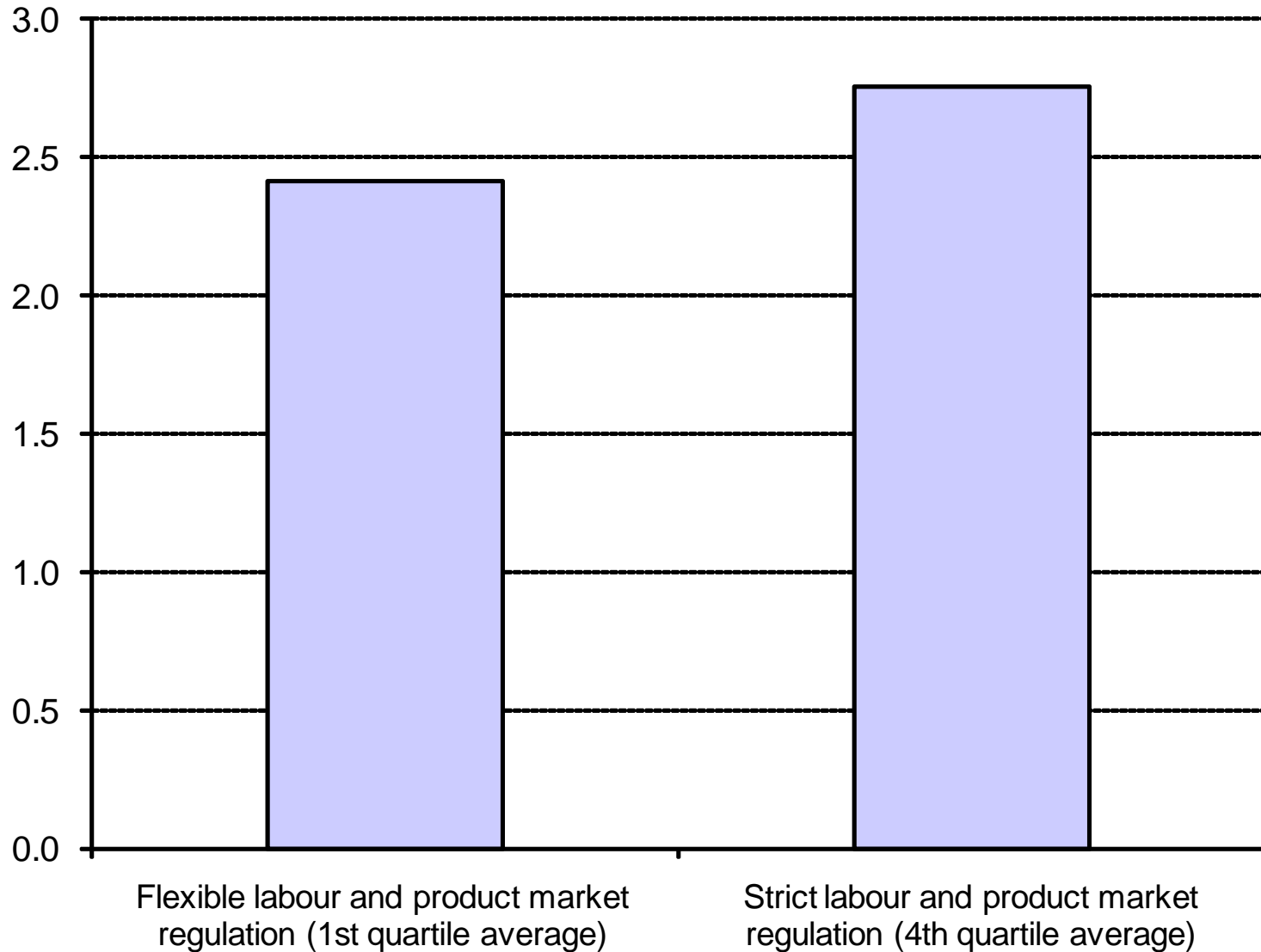


Note: The impact of automatic stabilisers is measured by the semi-elasticity of the unadjusted fiscal balance to changes in GDP (Girouard and Andre, 2005). The countercyclicality of discretionary fiscal policy is measured by the contemporaneous correlation between annual changes in the cyclically-adjusted primary balance and in the output gap.

Source: OECD.



Cumulative output loss following a shock (as a % of GDP, following a 1% negative common shock to GDP)



Source: Duval R. and L. Vogel, OECD Economic Studies No.44, 2008.

