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HOW DO GROWTH-PROMOTING POLICIES AFFECT MACROECONOMIC STABILITY?

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HOW DO GROWTH-PROMOTING POLICIES AFFECT MACROECONOMIC STABILITY?

Main Findings

- Policy reforms aimed at boosting long-run growth often have side effects – positive or negative – on an economy's vulnerability to shocks and their propagation.
- Much research has identified financial market deepening as supporting long-term growth. That the financial sector can also be a source of instability garnered less attention till recently, at least in policy recommendations. The crisis brought home that robust micro and macroprudential regulation needs to be in place to reap the benefits of deep financial markets without increasing economic instability.
- Trade and financial openness support growth but create vulnerabilities to external shocks. To address external imbalances and the risk of sudden stops of capital flows, fiscal policy may sometimes need to be tighter, impediments to direct and equity investment should be removed, and structural and financial policies more generally reformed to remove biases in capital flows contributing to financial account vulnerabilities.
- Monetary and budgetary policy settings aimed at low and stable inflation and sound public finances are conducive to long-term growth. And in most cases, maintaining sound public finances and anchoring inflation expectations will also help to contain shocks.
- Rigid labour and product market regulations can potentially create trade-offs between growth and stability. Policy settings which damp the initial impact of a shock can be harmful for long-run growth. However, new research using data covering the Great Recession, found no damping effects from such settings and furthermore found that they slowed the economy's recovery from a shock.

1. The economic policy recommendations of the OECD – such as those contained in *Going for Growth* and the *Economic Outlook* – draw on a large body of empirical work that has identified policy settings which support long-term growth. The underlying analysis has typically paid less attention to their consequences for macroeconomic stability. Macroeconomic shocks as severe and protracted as those since 2007 warrant a reconsideration of the role growth-promoting policies play in shaping the vulnerability and resilience to macroeconomic shocks. This note re-examines pro-growth policies considering whether they raise or lower the vulnerability to shocks or deepen and lengthen the impact of adverse shocks. The final section contains a summary analysis of policy effects on both the vulnerability to and the impact of shocks.

Vulnerability to shocks

2. Vulnerability, that is the probability that an economy may be hit by a shock, can arise due to a number of different growth-promoting policy settings. Notably these include policies influencing the development of the financial sector and asset prices as well as policy settings that expose economies to external trade and financial account shocks.

Financial and housing market liberalisation can cause sizeable shocks

3. Financial market deepening supports long-term growth, but its role as a source of instability was less studied prior to the crisis. For example, the development of housing and mortgage markets was

identified in empirical work as bolstering economic resilience and being conducive to higher output. A well-functioning mortgage and housing market can facilitate labour mobility and thus ensure a better matching between firms and jobseekers, hence boosting productivity. It was also observed that a deep mortgage market provides an important channel for the transmission of monetary policy, which should, in principle, augment the capacity of monetary policy to stabilise the economy.

4. However, the development of deeper mortgage markets may contribute to heightened macro-economic vulnerability with large associated costs when these markets crash. One channel through which deep and liberalised mortgage markets increase the risk of harmful macroeconomic shocks is the possible amplification of asset price developments. Higher asset prices allow households and firms to take on more debt (for example, through mortgage equity withdrawal), increasing the possibility of a large shock occurring. Indeed, high levels of private sector debt relative to trend help predict recessions. While the predicted probability of a recession occurring in the following year is around 10% when household debt is at trend, it rises to over 40% once debt rises above trend by 10% of GDP (Sutherland and Hoeller, 2012).

5. In retrospect it is clear that a more nuanced approach to financial market liberalisation is warranted. In particular, liberalisation needs to be accompanied by robust micro and macroprudential regulation to counteract risks emerging from rapid financial innovation, the adverse incentive structure in the financial sector and moral hazard problems arising from systemically important financial institutions. Even with robust prudential policy in place, macroeconomic policy may need to react to emerging threats from the financial sector and asset price bubbles and structural policies should be set bearing in mind the effect they have on macroeconomic stability:

- There is a case to consider the effect of asset price movements on inflation over a sufficiently long time horizon so that monetary policy can react to the threat of emerging bubbles and thus contributes to financial stability, even though interest rates are a blunt instrument with the costs felt widely across the economy.
- A regulatory framework that ensures a higher flexibility of housing supply ought in principle to be good for growth and reduce the risk of house price bubbles. Even if this is obtained at the price of greater volatility of building activity, it is likely to have a positive overall effect on stability, given the very high cost of housing bubbles.
- Both long-run growth and stability will be served by avoiding debt biases in the tax code – particularly for the housing market.

Financial openness and external imbalances create vulnerabilities to external shocks

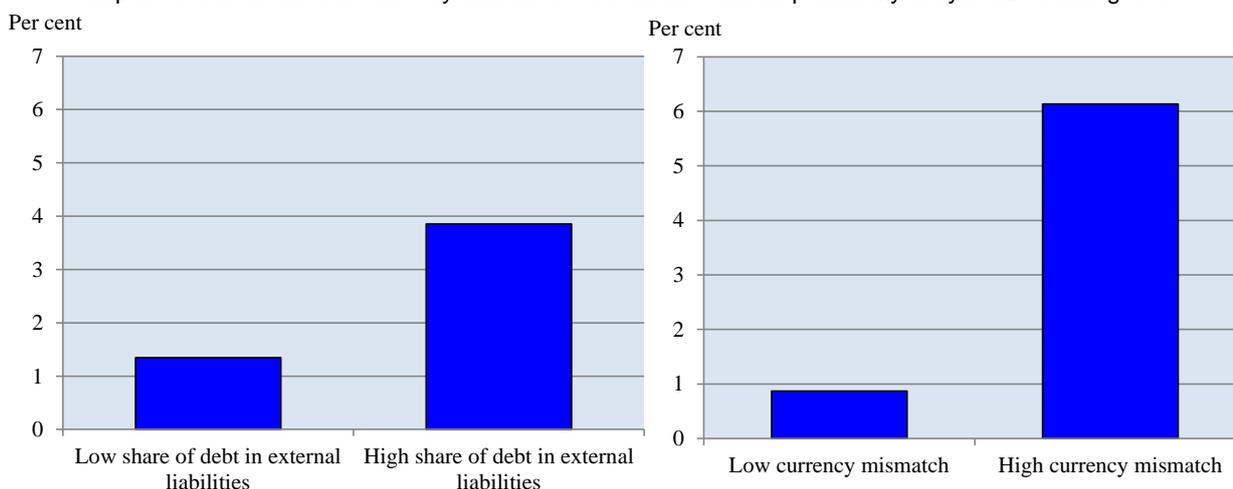
6. Financial openness can in principle offer important advantages in terms of long-term growth and welfare. For example, openness allows greater portfolio diversification and possibly higher rates of return. For the recipient country, openness allows greater risk sharing and may help smooth output in the face of idiosyncratic shocks. However, vulnerabilities may build in the financial account, heightened, for example, by a large share of debt, especially of (short-term) bank debt in total external liabilities and currency mismatches (Figure 1). Abrupt swings in lending from abroad can lead to sudden stops, put pressure on exchange rates and leave domestic financial institutions vulnerable to default risk.

7. As with domestic financial market liberalisation, better policy frameworks could help reduce the trade-off between policy objectives. Structural policies should complement openness to reduce the risk of foreign financial shocks. In particular, tax codes that bias debt over equity finance appear to contribute to a higher risk of financial crises by favouring more volatile types of capital inflows. Tax treaties that do not discriminate against foreign direct investment and structural policies that remove barriers to FDI and

enhance product market competition appear to reduce the risk of a banking crisis, by removing biases towards debt rather than equity in foreign funding. Recent evidence also suggests that trade openness reduces vulnerabilities to sudden stops in capital flows (Frankel and Cavallo, 2013). Moreover, the fact that fast rising house prices are associated with a bias towards external debt suggests that macroprudential policies directed towards damping housing market exuberance may contribute to reducing this risk.

Figure 1. A high debt share and large currency mismatch increase crisis risk

Impact of debt share and currency mismatch on countries' annual probability of systemic banking crisis



Note: Bars represent, for two possible levels of the share of debt in external liabilities (the currency mismatch), the annual probability of suffering a systemic banking crisis. OECD countries are split into two equally-sized groups based on the size of their share of debt in external liabilities (currency mismatch). The low share of debt in external liabilities (low currency mismatch) is defined as the average across the low debt-share (low currency mismatch) group, with the high share of debt in external liabilities (high currency mismatch) being defined correspondingly.

Source: OECD calculations based on Ahrend and Goujard (2012).

Fiscal and structural policy can reduce external imbalances

8. While sometimes consistent with promoting long-term growth and welfare, persistent external imbalances raise the risk of a disorderly adjustment and macroeconomic instability. Given the macroeconomic consequences, the appropriate fiscal policy when current account deficits are large acquires even more importance. Changing fiscal policy in response to external imbalances – which may be largely driven by private sector saving and investment decisions – may in some circumstances be an appropriate response. Recent work (OECD, 2011) suggests that a fiscal tightening can reduce external deficits and that the impact may be sizeable, with estimates suggesting that a 1% of GDP tightening of the fiscal balance raises the current account balance by up to around 0.5% of GDP.

9. For countries running current account deficits, relatively few policy options exist to address external imbalances and reduce potential instability. However, since countries with external account deficits are also often countries with large fiscal consolidation needs, pursuing consolidation combined with structural reforms could make a contribution towards addressing imbalances and enhancing stability. In other cases, addressing external imbalances may incur no trade-off with policies promoting long-run growth. Countries with current account surpluses have a variety of policy options to address imbalances. For example, product market deregulation in sheltered sectors may help reduce the imbalances by promoting investment (OECD, 2011). More relevant for emerging economies running surpluses, developing social welfare systems could enhance overall welfare and reduce the need for precautionary saving. Financial market deepening could reduce borrowing constraints and thus the saving rate while also enhancing the allocation of capital and supporting growth. Finally, pension reforms that increase the length of the working life would act to reduce household saving (at least for some time) while boosting growth.

Shock impact and duration

10. Policies not only affect the vulnerability to shocks but can influence how large the shock is and how long it lasts. This section considers how growth-promoting macroeconomic and structural policies affect how hard the economy is hit by a shock and how they affect the ability to bounce back.

Some aspects of macroeconomic stabilisation need to be reconsidered

11. Monetary and budgetary policy settings aimed at low and stable inflation and sound public finances are conducive to long-term growth. These policies also play a key role in stabilising the economy. For example, monetary policy that has firmly anchored inflation expectations will allow a stronger response to shocks and helps guard against deflationary spirals in the wake of large negative shocks. However, the difficulties in conducting monetary policy with the usual interest rate instruments during and after the Great Recession provoked some discussion about the appropriate inflation target for monetary policy. While raising the inflation target could create additional room for monetary policy to react to a severe downturn, the transition to a new target would involve costs and, presumably, instability. The reassessment of monetary policy has also raised the possibility of other far-reaching changes. For example, the absence of memory in inflation targets at a moment when inflation has been undershooting and unemployment remains high has been questioned. However, the proposals of price level or nominal GDP targeting raise issues of implementation and credibility. At this moment it is not clear that a better alternative to flexible inflation targeting with a sufficiently long horizon is available.

12. Sound public finances can mitigate shocks by enhancing stabilisation policy. Low government debt levels and sustainable fiscal balances provide fiscal policy room to counteract large, adverse shocks and absorb contingent liabilities. In some countries, pre-crisis policies focused too little on reducing debt to prudent levels. The commitment to a prudent debt target would provide an anchor for fiscal policy, countering the upward trend in debt experienced in many OECD countries before the crisis.

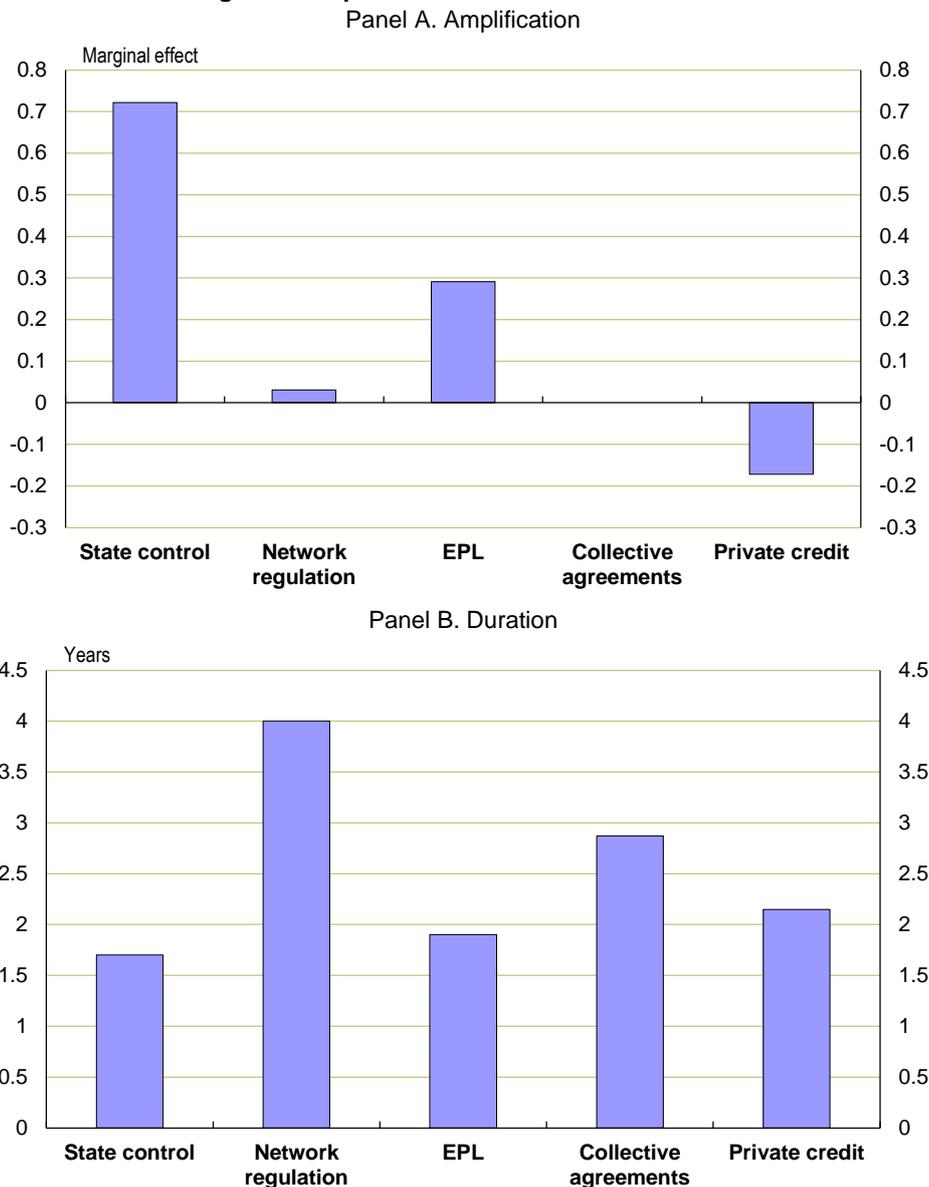
13. Typical growth-enhancing tax and spending reforms have implications for macroeconomic stabilisation by modifying the size of the automatic stabilisers, often by weakening them. The shift in the structure of taxation from income to consumption-based taxes - seen as generally enhancing growth - would imply smaller automatic stabilisers. On the spending side, reducing the generosity of unemployment benefits may lower unemployment in the long term but would likely weaken the automatic stabilisers, which may, hence, run counter to the stability objective (though this may be offset by additional spending on active labour market policies). This trade-off between stability and growth objectives may call for more active macroeconomic policies in the face of demand shocks. That said, making policies state contingent, for instance, by prolonging unemployment benefit payments temporarily during a downswing, might also ease the trade-off between stability and long-term growth.

Structural policies and shock amplification and persistence

14. Structural policies also shape the resilience of the economy to shocks. The experience of the Great Recession provided new evidence on possible trade-offs between growth and the impacts and duration of shocks. Previous empirical evidence generally found that rigid labour and product market regulations were costly for long-term growth, but that such policy settings may damp the initial impact of a shock at the cost of raising the persistence of the shock. New findings covering the recent crisis found no damping effects from such settings and furthermore these regulations lead to greater persistence of a shock (Sutherland and Hoeller, 2013). For example, more stringent state control of enterprises and employment protection legislation appear to amplify the impact of shocks hitting OECD economies (Figure 2, Panel A) and increase the time it would take for the economy to recover after a shock (Figure 2, Panel B). More rigid network regulation and a broader coverage of collective agreements appear to have little effect on the amplification of shocks hitting the economy, but do appear to increase the duration of a shock. Hence, the

trade-off that had been supposed to exist before the Great Recession did not seem to manifest itself in the wake of the crisis. On the other hand, well-developed financial markets as measured by the ratio of private credit to GDP appear to help reduce the amplification of common shocks, though the recovery will be less swift. This does not imply, however, that a country with a larger financial sector that is hit by a financial shock will face smaller adverse consequences.

Figure 2. Amplification and duration of shocks



Note: Panel A shows the estimated impact of different types of policies on the amplification or damping of common shocks hitting OECD economies. The value shown is the marginal impact of the shock evaluated at the policy mean value, implying that a shock would be amplified by 10% if the estimated marginal impact is 0.1. Panel B shows the total time taken in years for the economy to recover by one-half after a negative shock. The shocks can be idiosyncratic as well as common. The figure shows the time in years, evaluated when the policy setting is at a high level (for example, a country like Sweden with respect to employment protection legislation for regular workers).

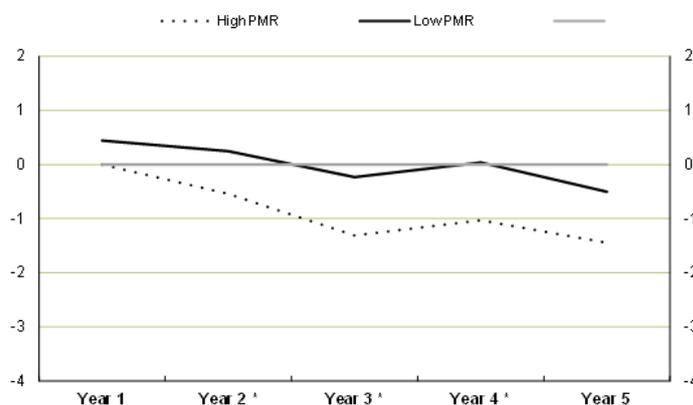
Source: OECD (2013), OECD Economic Outlook No. 92, *Statistics and Projections* (database).

15. Labour market policies that promote employment and growth, such as active labour market policies are conducive to growth and have helped contain the threat of hysteresis during the recent crisis.

The experience of countries during the crisis also suggests additional policies which may have a role to play in moderating the impact of the shock. For example, short-term working schemes helped cushion the impact of the recent crisis. However, if not well-designed they may prevent or retard structural adjustment or augment wage pressures, implying a trade-off with long-term performance.

16. Light product market regulation may not only be good for long-term growth but may also reduce the persistence of a shock by facilitating resource reallocation. This is likely to be particularly important following a supply-side shock, as suggested by new OECD empirical research. For example, estimates of how product market regulations affect how economies react after a sharp supply-side shock suggest that having light product market regulations will reduce the initial impact (Figure 3) and help the economy recover more quickly (Sutherland and Hoeller, 2013).

Figure 3. GDP developments following a large supply-side shock
Effect of a large shock when product market regulation is more and less restrictive



Note: The figure shows the per cent change in output following a large negative shock to the terms of trade (a shock greater than one and one half standard deviations of annual fluctuations in the terms of trade). The paths is based on estimates using local projection methods that also control for the state of the cycle via the output gap at the time of the shock and trade openness. If a test for the joint significance of the coefficients is statistically significant at the 10% level, the year is marked with *. The estimation results are used to calculate paths for hypothetical economies with more or less restrictive product market regulations. The magnitude of the difference is approximately the difference between the restrictiveness of product market regulation in New Zealand and Ireland.

Source: OECD (2013), OECD Economic Outlook No. 92, *Statistics and Projections* (database).

17. Housing sector policies have previously been identified as a key factor that could enhance the resilience of an economy to economic shocks. While housing market and related financial market policies created vulnerabilities to shocks (see above), whether they amplify or damp the impact of a shock is less clear. Well-developed housing markets can help reduce the size and persistence of a shock by aiding the transmission of monetary policy. As a result of more potent monetary policy, when hit by a negative shock, an economy would experience a smaller initial output fall and less persistence. But when the shock affects the operation of financial markets a well-developed mortgage market may intensify the impact of the shock. However, as noted above, new empirical evidence suggests that deeper credit markets appear to moderate the size of shocks, other things being equal, even when the analysis covers the Great Recession (Sutherland and Hoeller, 2013) and that housing slumps in countries with well-developed mortgage markets have tended to be shorter (Bénétrix *et al.*, 2012).

Trade-offs and complementarities

18. Some policies that underpin long-term growth also bolster macroeconomic stability, while for others there may be a trade-off as they can raise vulnerabilities to shocks as well as amplify shocks and increase their duration. Table 1 illustrates in a judgemental and selective manner some possible trade-offs and complementarities between the growth-enhancing objective and the various stability dimensions.

- Some growth-promoting policies complement macroeconomic stability. For example, a low level of public debt is not only good for medium and long-run growth, but can help reduce the different dimensions of macroeconomic instability as it allows the unfettered working of the automatic stabilisers and the use of discretionary policy to cushion a shock. Less strict product market regulations boost long-term growth while simultaneously reducing the amplitude of shocks and their persistence, and less rigid product market regulations also help ease vulnerabilities to the extent they favour more stable capital flows. Similarly, lower restrictions on foreign direct investment support growth and by reducing the bias of capital flows towards debt and hence the likelihood of external financing shocks, also buttress macroeconomic stability.
- For a range of policies, trade-offs between long-term growth and some instability dimensions exist, while they may be complements in others. For example, financial market liberalisation increases the vulnerability of the economy to shocks. However, deep financial markets can assist monetary policy in damping shock amplification, unless they are impaired, and can help limit persistence.
- Finally, a number of policies, such as those affecting trade and financial openness, may increase the vulnerability of the economy to shocks and contribute to greater shock amplification and possibly persistence. In such cases, flanking policies may be needed to insulate the economy better from the adverse consequences of shocks.

Table 1. The effects of policies on growth and macroeconomic instability

A rise in:	Affects GDP per capita	Affects shock vulnerability	Affects shock amplification	Affects shock persistence
	with this sign			
Labour taxation and the tax wedge	-		-/+	-
Employment protection	-		+	+
Intermediate collective bargaining	-		-/+	+
Collective bargaining coverage	-		-	-
Unemployment benefits	-		-	+
Spending on active labour market policies	+			-
Early retirement and easy access to disability schemes	-		-	+
The share of indirect/property taxes in government revenue	+		+	-
Product market regulation	-	+	+	+
FDI restrictions	-	+	(+)	
Trade policies boosting openness	+	+	(+)	(+)
Financial market liberalisation	+	+	-/+	-
Prudential regulation	-/+	-	-	
Public debt	-	+	+	+
Public deficit	-	+	+	+
Target inflation rate	-		-	
Target inflation horizon	+	-		

Note: The table draws on the fuller analysis in Sutherland and Hoeller (2013). A sign in parentheses indicates that the effect is uncertain.

Suggested further reading:

OECD (2013), *Growth and Macroeconomic Stability*, OECD Economic Policy Papers, No. 3.

Sutherland, D. and P. Hoeller (2013), “Growth-promoting Policies and Macroeconomic Stability”, *OECD Economics Department Working Papers*, No. 1091, OECD Publishing.

Ziemann, V. (2013), “Do Structural Policies Affect Macroeconomic Stability?”, *OECD Economics Department Working Papers*, No. 1075, OECD Publishing.

Additional related papers include:

Ahrend, R., J. Arnold and C. Moeser (2011), “The Sharing of Macroeconomic Risk; Who Loses (and Gains) from Macroeconomic Shocks?”, *OECD Economics Department Working Papers*, No. 877, OECD Publishing.

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Frankel, J. and E. Cavallo (2013), “Does Openness to Trade Make Countries More Vulnerable to Sudden Stops, or Less? Using Gravity to Establish Causality”, *NBER Working Paper*, No. 10957.

OECD (2011), “Tackling Current Account Imbalances: Is there a Role for Structural Policies?”, Chapter 5 in *Economic Policy Reforms 2011: Going for Growth*, OECD Publishing.

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Sutherland, D., P. Hoeller, B. Égert and O. Roehn (2010), “Counter-cyclical Economic Policy”, *OECD Economics Department Working Papers*, No. 760, OECD Publishing.

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