New Approaches to Economic Challenges [B12b]
Increasing the resilience of economies to external shocks (Finance and Resilience)

THEME OF THE PROJECT

Growth-promoting policies can influence macroeconomic instability ...

Growth-promoting policies can play a role in shaping the vulnerability and resilience of an economy. Such policies can affect the vulnerability of an economy, amplify or dampen shocks, and influence the persistence of their effects. For instance financial openness and deepening are a source of transmission and propagation of shocks.

... but the welfare implications can be understood by looking at microeconomic instability

The true welfare costs of economic instability can only be understood at the micro level by assessing the impact of shocks on firms, households and individuals. The project traces the type and size of volatility of micro-level variables and looks at policy trade-offs between growth, microeconomic instability and income inequality.

RESULTS OF THE WORK STREAM

This study examines microeconomic stability ...

Microeconomic volatility affects households and firms directly, lowering on average life satisfaction. Furthermore, volatility is much higher at the micro than at the macroeconomic level.

... at the household level ...

Aggregate level data obscures the effect of higher economic instability on household-level disposable income. Household-level instability has many underlying causes. For instance, during the Great Recession, many countries that suffered large macro-shocks experienced little increase in micro-level instability, at least initially.

In general, household-level instability tends to be greater in more unequal countries. A possible cause is that the tax and benefits system help to ameliorate both inequality and volatility.

... at the firm level ...

Firm-level instability can indirectly generate welfare-reducing costs, but it can also reflect healthy processes of resource reallocation, which underpin creative destruction and economic growth. Firm-level instability is in general greater in countries with lower levels of employment protection, stronger contract enforcement and lower levels of public ownership.

... and at the individual level

Employee-level economic instability can take the form of changes in jobs, both in and out of employment, working-time or hourly earnings. All these forms of economic instability vary considerably across countries.

NEW APPROACHES

Three measures of volatility utilise different levels of data disaggregation

Volatility can be measured in three different ways at the micro level. A rolling window measure allows fluctuations around average growth to be measured for each individual. Incidence of large changes counts the proportion of individuals who are subject to significant change. Cross-sectional measures can be used to evaluate the dispersion of individual changes around the average. All three methods are highly correlated with each other and are tested in an econometric investigation against policy indicators and other relevant factors. The individual-level data used in this study cover 26 countries from 1994 to 2010.

POLICY IMPLICATIONS

Microeconomic volatility and inequality are tightly connected ...

Microeconomic volatility strongly affects economic welfare. Changes in the economic situation of individuals, which are difficult to predict, reduce welfare because most people are risk-averse. Furthermore, household disposable income tends to be less volatile in more equal countries. This may be explained by policies such as progressive taxes and transfers, which reduce both inequality and volatility. These two issues are intertwined because compressed earnings distributions restrain the extent to which individual income can rise or fall in the face of shocks or opportunities.

Growth-enhancing policies can heighten volatility and income inequality ...

Pro-growth reforms, such as expanding active labour market programmes, reducing employment protection for regular workers and limiting unemployment insurance, tend to boost growth for a given level of instability.

Some pro-growth reforms can exacerbate income inequality and potentially micro level volatility if their design pays insufficient attention to their distributional consequences . Reductions in progressive taxes and transfers are an important category of pro-growth reforms that raise trade-offs between growth, inequality and volatility. By contrast, reforms that make labour and product markets very fluid reforms improve stability and income inequality as well as long-term growth.

Specific structural reforms have an impact on individual-level volatility ...

Relaxing employment protection legislation for regular workers and product market regulation from very tight to moderately tight restrictions increases worker-level economic instability. However, deeper reforms which result in highly flexible labour markets and very competitive product markets bring greater individual-level economic stability (in addition to stronger growth).

More spending on active labour market policies reduces gross worker flows, presumably by improving the matching process in hiring.

Centralised and decentralised wage-bargaining systems bring greater worker-level stability in hours worked and hourly earnings than intermediate, sector-level arrangements.

Higher levels of unemployment benefits are associated with greater worker-level volatility in hours worked and hourly earnings. This link may reflect that stronger unemployment insurance facilitates risk taking in the labour market.

and more progressive taxes can dampen large economic shocks for individual earners

Progressivity in income taxation can dampen the transmission of large changes in labour earnings to household disposable income. Social transfers also reduce the transmission of shocks from labour earnings to disposable household income, but to a lesser extent than taxes. Changes in labour earnings by other household members are also an important

PROJECT PAPERS

- **Cournéde, B., Garda, P., P. Hoeller, V. Ziemann (2014),** ''Effects of economic policies on microeconomic stability'' ECO/CPE/WP1(2014)20
- **Garda, P. and V. Ziemann (2014),** "Economic Policies and Microeconomic Stability: A Literature Review and Some Empirics," OECD Economics Department Working Papers, No. 1115.
- **Sutherland, D., Hoeller, P., (2013)** "Growth-promoting policies and macroeconomic stability", OECD Economics Department working papers, No 1091, OECD Publishing.
- **Ziemann, V., (2014)** "A framework for assessing the trade-off between growth and microeconomic volatility - Background paper", ECO/CPE/WP1(2014)9 and "- Presentation", ECO/CPE/WP1(2014)10

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