Strengthening Economic Sustainability and Resilience at a Time of Crisis

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Outline

1. Sustainability and Resilience at a Time of Crisis

2. Macro-Financial and Structural Policy Challenges
1. Sustainability and Resilience at a Time of Crisis
Sustainability and Resilience at a Time of Crisis

• **Sustainability (S):** meeting present requirements without compromising future

• **Resilience (R):** capability to resist large shocks

• **S+R:** strongly interrelated as shown by ongoing crisis

• **Systemic view:** economic S+R are also strongly linked to social, environmental, and political S+R; examples:
  1. Economic crises beget social costs and political crises
  2. Globalization, income concentration, and social demands
  3. Environmental unsustainability implies economic unsustainability

• **More narrow focus here:** economic S+R
Current Crisis

• **2007-2008 crisis origins**: Advanced economies’ (AEs) fiscal and monetary unsustainability, compounded by financial policy and market failures

• **2008-09 policy response**: timely, massive, global financial + macro rescues avoided Great Depression

• **Since 2009**: lack of timely fiscal adjustment and of financial and structural reforms in most AEs leads to tepid recovery and euro crisis cum recession

• **2012 - ?**: uneven world growth, large uncertainties
AEs: Weakest Recession Recovery since WWII

Sluggish and Uneven Growth, Recession in Europe

Large and Rising Macro and Policy Uncertainty

2. Macro-Financial and Structural Policy Challenges
1. **Fiscal statistics**: key role of timely, transparent, and relevant data
   - Data transparency: Greece vs. Norway
   - Generational accounting: US$ 16 tr. U.S. explicit government debt versus 320 tr. total gov. debt (L. Kotlikoff)
   - Reversal of world fiscal sustainability since the 1990s: fiscal virtue in EMDEs, fiscal profligacy in AEs

2. **Fiscal sustainability**
   - Key economic S+R: low debt, sustainable balances
   - Virtuous cycle of debt, credibility, spreads, market access
Fiscal virtue in EMDEs, fiscal profligacy in AEs

Fiscal Policy (2)

3. Counter-cyclical (or at least a-cyclical) fiscal policy
   - Key for fiscal sustainability and macro stabilization
   - Shaped by fiscal and political institutions and financial development (Calderón and Schmidt-Hebbel 2010)

4. Strong fiscal institutions
   - Fiscal rules (e.g., Norway, Germany, Colombia, Chile)
   - Sovereign wealth funds (Commodity exporters: Norway, Chile, Kuwait, Alaska)
   - Fiscal councils (Germany, UK, U.S. CBO)
   - Accountability + transparency (South Africa, New Zealand)
Differences in fiscal counter-cyclicality between AEs and EMDEs, 1975-2005 (Calderón and Schmidt-Hebbel 2008)

8.1. Budget balance

8.2. Government expenditure

8.3. Current expenditure

8.4. Capital expenditure
1. Monetary Policy
   • Inflation targeting (IT) is still the best monetary policy (MP) framework (Mishkin and Schmidt-Hebbel, Geraats)
   • Post-crisis risks + challenges posed to IT and non-IT MP:
     • Leaning against the wind during booms
     • Unorthodox monetary/credit easing during crises
     • Unwinding massive balance-sheet expansions after crises

2. Exchange-rate policy
   • Crisis underscores benefits of ER flexibility
   • Evidence shows limited effectiveness of ER interventions
   • Evidence shows limited growth effects of systematic ER under-valuation (when feasible)
Inflation Targeting supports Monetary Policy Efficiency and Transparency

Sources: Miskin and Schmidt-Hebbel (2007); Geraats (2008).
Macro-Prudential and Financial Policies (1)

• **Crisis:** in addition to massive macro policy failures, caused by major financial policy and market failures:
  • Complexity and opacity of financial assets + institutions
  • Excessive risk taking by households + financial institutions
  • Absence of meaningful financial regulation and supervision
  • Massive under-estimation of tail risks and panic spreading due to financial connectedness (Billio et al., 2012)
Globalization: Growing Connectedness between Sovereigns, Banks, and Insurance Companies before and after Crisis

Sources: Billio et al. (2012).
Macro-Prudential and Financial Policies (2)

- Policy challenges:
  1. Strengthen financial and macro-prudential regulation of banks and non-bank SIIIs (Basle III and beyond)
  2. Strengthen corporate governance, transparency and accountability of banks and non-bank SIIIs
  3. Re-think (revise, minimize) explicit and implicit financial government guarantees extended to individuals (Fannie & Freddie; unlimited deposit insurance) and financial institutions (too big to fail – limit/tax financial institutions by size?)
Structural Policies

• **Focus on growth:** necessary condition for economic S+R

• **Policy challenges:**
  
  (1) **Strengthen goods and labor market competition** (e.g., OECD’s “Going for Growth”, country work)

  (2) **Foster unilateral and multi-lateral globalization:** full trade integration, full financial integration (no capital controls), growing labor migration

  (3) **Strengthen regional and global international coordination regarding:** adopting common norms and regulations; preventing/addressing crises
Macro, Financial, and Structural Policy Interaction

• There is much evidence on the positive interaction between good macroeconomic, financial, and structural policies on economic sustainability and growth

• Complemented by more recent evidence on the benefits of good macro, financial, and structural policies to strengthen country resilience to crises:
  • IMF WEO (Oct. 2012) on expansions and recoveries
  • Corbo and Schmidt-Hebbel (2010) on structural and macro policy improvements in Latin America
Effects of Policies on Expansion and Recovery Duration in the World

Effects of Structural Features on Expansion and Recovery Durations in the World

Effects of Foreign Shocks and Domestic Conditions on Latin America’s 1998-99 and 2008-09 Recessions

Source: Corbo and Schmidt-Hebbel (2010)
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