

## CHAPTER 6

## COUNTER-CYCLICAL ECONOMIC POLICY

## Introduction and summary

***The crisis has prompted a re-think of policy settings***

The recent economic crisis has stretched policy frameworks in many OECD countries to breaking point. As economies begin to recover lessons are being drawn on how policies can better prevent the development of new large imbalances and asset price misalignments that were at the origin of the crisis. In addition, policies will have to be set so as to enhance the ability of economies to withstand large adverse shocks.<sup>1</sup>

***Policy will need to be more prudent during upswings***

An important lesson from the severity of the recent recession is that policy in various areas will have to be more prudent during upswings and to build in greater safety margins to be able to react to large adverse shocks. The main policy conclusions of the OECD's recent work on counter-cyclical economic policy are as follows:

- Policy decisions have to be made in an environment of uncertainty. As far as possible, they should be robust to erroneous information about the functioning of the economy, the nature of economic shocks or the effects of policy. Moreover, risk assessment tools, such as early warning systems, need to be developed further.
- The room for fiscal policy to react to a downturn is constrained by budget deficits and debt at the outset. In general, the poorer the fiscal position the less reactive governments have been and can be in their response to adverse shocks. Fiscal rules can help prepare for the next downturn by leading to swifter consolidation during the upturn. But inappropriate rules can be destabilising and lead to behaviour aimed at respecting the letter but not the spirit of the rule.
- The monetary and financial policy framework needs some re-thinking following the crisis to achieve a better articulation between economic and financial stability. Identifying asset price bubbles can be hard and containing them with monetary policy could entail large collateral damage to activity. However, there may be a case for leaning against the wind, if asset prices are driven by a credit boom and financial regulation is judged to be insufficiently robust.

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1. Recent work by the OECD Economics Department has examined how policies have interacted with the cycle over time and during the recent crisis and addresses the policy issues in greater depth (Sutherland *et al.*, 2010).

- Financial policy needs to strengthen micro-prudential regulation, including by increasing capital and liquidity buffers so that financial institutions can withstand adverse shocks. Furthermore, regulatory interventions may need to target emerging credit-driven bubbles and macro-prudential policies should address systemic weaknesses. As demonstrated by the financial crisis, this needs to take into account international financial linkages.
- Changes to structural policy settings, including in areas like taxation and housing, can improve the resilience of the economy to shocks and affect the degree of leverage households and firms take on.
- In a number of cases, more policy co-ordination would be desirable. The effective regulation of financial sectors would benefit from international co-ordination to ensure a level playing field and that possibilities for regulatory arbitrage are minimised. In response to large common shocks an international co-ordination of fiscal and monetary policy responses may be appropriate.

### **The nature of the cycle**

*Macroeconomic policies have helped reduce volatility, but vulnerabilities emerged*

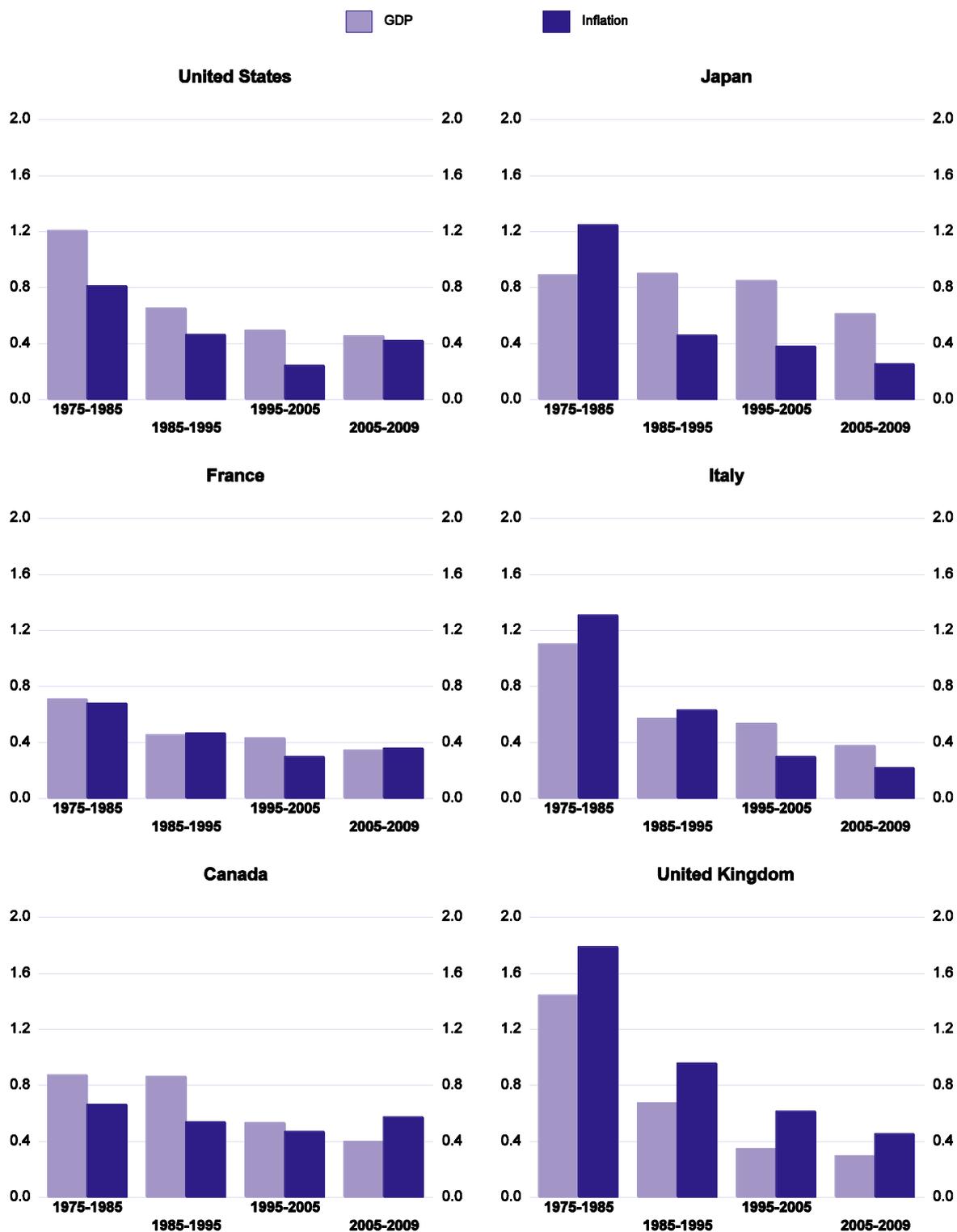
Since the mid-1980s, business cycles have tended to become smaller in amplitude and longer during the expansionary phase with fewer recessions. Monetary and structural policies appear to have contributed to the “great moderation” (Figure 6.1), by better anchoring inflation expectations and by reducing rigidities that hindered economic adjustment to shocks. However, the reduction in macroeconomic volatility was accompanied by greater asset price volatility. The flip-side of the great moderation was greater risk-taking, which in combination with financial market innovations fuelled a considerable rise in private-sector debt, which proved to be a source of fragility in many countries (Figure 6.2).

*The banking sector has become more pro-cyclical...*

The banking system has become more pro-cyclical (Égert, 2010b). For example, the ratio of bank assets to GDP has moved ever more closely with the cycle since the late 1970s and this has been accompanied by a rising number of banking crises. Furthermore, banks have become increasingly leveraged (even if this was partially hidden from the regulators) and their financing structure has shifted away from deposits in many countries.

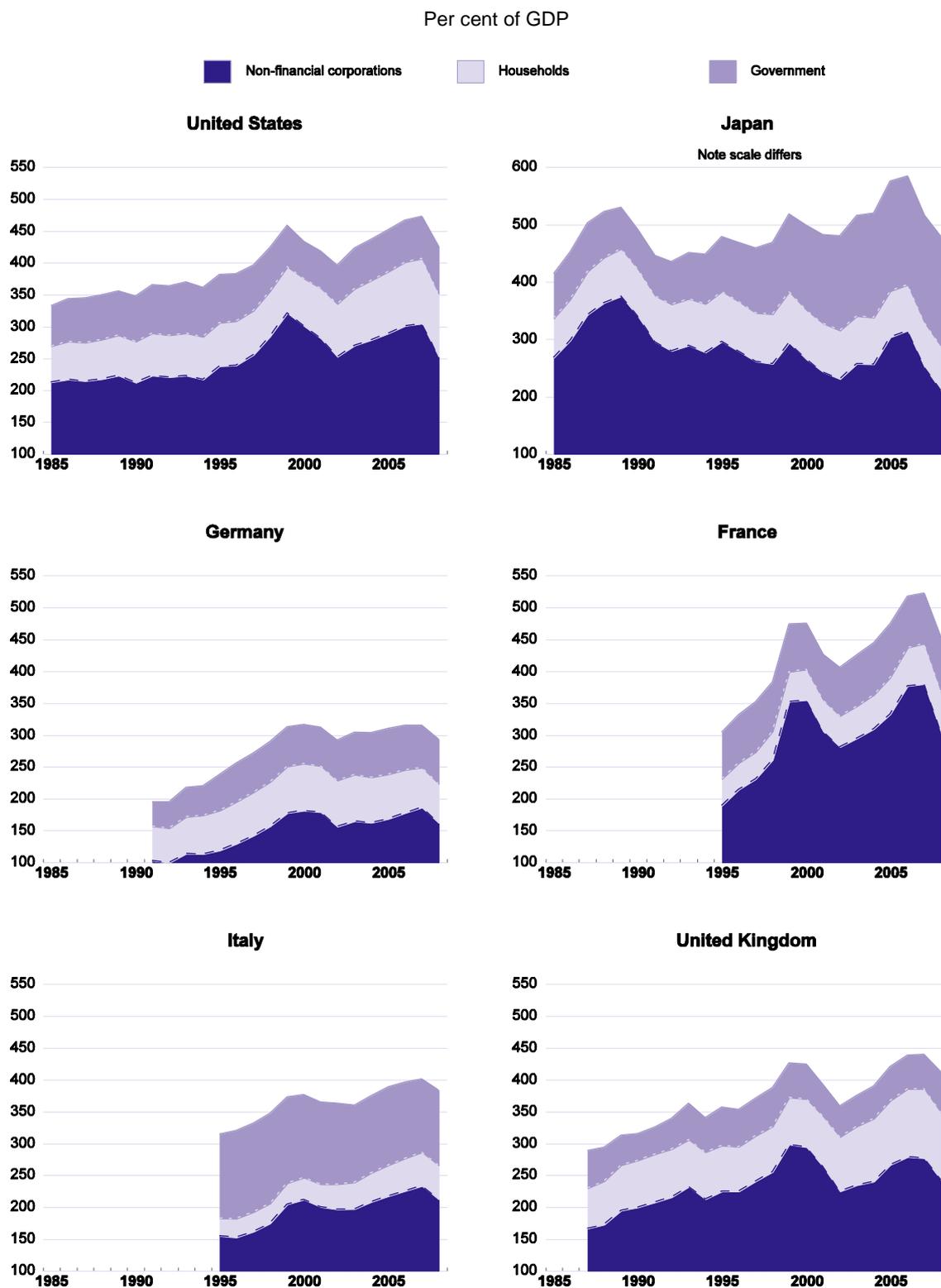
**Figure 6.1. The great moderation**

Period averages of 20-quarter rolling standard deviations of quarterly real GDP growth and quarterly inflation rate, as measured by the CPI



Source: OECD Economic Outlook 87 database.

Figure 6.2. Household, government and non-financial corporation liabilities



Source: OECD Annual National Accounts.

***... for a number of reasons...***

Pro-cyclical behaviour in credit supply can arise for a number of reasons: first, bank capital requirements, which are linked to the perceived riskiness of the assets, can induce pro-cyclical behaviour if, for example, banks find it easier to adjust lending than capital to changing assessments of the riskiness of assets. Second, provisioning for bad loans can be pro-cyclical, as it often increases sharply during downturns. By depressing profits it can have an impact on banks' ability to lend. Developments on bank balance sheets have reinforced pro-cyclical behaviour. For example, banks that hold many illiquid assets or are reliant on short-term funding may be prone to pronounced pro-cyclical behaviour in lending, when liquidity dries up. Finally, other factors that can influence the pro-cyclical behaviour of lending include risk assessment that is unduly pro-cyclical and remuneration policies that encourage excessive risk taking. To some extent, these outcomes are features of the regulatory set-up, though a number of countries have attempted to address some of these problems. For example, in Spain bank regulators have attempted to reduce the cyclical nature of provisioning by introducing so-called "dynamic provisioning", which induces banks to make more provisions in good times to provide greater buffers to absorb losses in bad times.

***... which can make the cycle more volatile***

The pro-cyclical behaviour of the banking sector can amplify cycles in the real economy and financial market instability can lead to severe downturns as demonstrated again by the recent economic and financial crisis. At the same time, the greater role for securities markets has created a new set of vulnerabilities as they have been prone to the drying-up of liquidity at times of tension.

***Shocks originating in the financial sector can spread rapidly abroad***

The financial shocks originating from the United States in 2007 and 2008 were transmitted remarkably quickly to the rest of the world. Financial market integration, operating through financial flows, credit losses and valuation changes, and trade openness were key elements of the rapid and strong transmission, magnified by intra-industry trade within subgroups of countries. Small open economies, in particular, are vulnerable to such shocks, as their trade openness is often a multiple of that of the large countries, while their financial markets often lack depth. Furthermore, a high degree of synchronisation can imply limits on an individual country's ability to stabilise the economy and may call for greater international policy co-ordination.

### Smoothing the cycle

*While there is a strong case for macroeconomic stabilisation, the desirable degree depends on a number of factors*

Macroeconomic policy should contribute to stabilising output and inflation as households and firms may find it impossible on their own to cope with large fluctuations. In addition, large and protracted recessions can lower the productive capacity of the economy, by affecting the level of structural unemployment (see Chapter 5), thus strengthening the case for a vigorous policy response to cushion steep downturns. While there is a strong case for stabilisation, the desirable amount of stabilisation is more difficult to pin down. Factors influencing the desired degree of stabilisation include:

- Whether the shocks hitting the economy are predominantly supply or demand shocks. Macroeconomic policies that help stabilise the economy typically have a more straightforward role in dealing with aggregate demand shocks, but may hinder the necessary adjustment to a permanent supply shock.
- The nature of the economy, the kinds of disturbances to which it is exposed and its ability to withstand shocks also influence how much and which kind of stabilisation is appropriate. For example, small open economies are likely to be more exposed to external shocks and can face considerable difficulties in stabilising the economy (see below). In this light, small open economies may put greater weight on policies that enhance the resilience of the economy.
- Unless carefully designed, stabilisation efforts may undermine so-called “instrument stability”. Specifically, attempts to fine-tune the economy may require ever larger policy measures to offset the effects of past policy decisions. This can be important as it may undermine the credibility of policy.

*Monetary policy is usually the primary tool to stabilise the economy,...*

Monetary policy provides an important means of stabilising both inflation and output. Countries differ in the weight they give to stabilising inflation and output. In some countries, such as the United States, the central bank has an explicit mandate to target both inflation and output, whereas in others, such as the United Kingdom, the mandate establishes a specific target for inflation but not output. Despite differences in mandates, monetary policy has generally been very successful in bringing down inflation rates as well as their volatility. In very large part, this has arisen due to the successful anchoring of inflation expectations at low and stable rates. This success, however, needs to be qualified. First, in some countries, monetary policy during the 2000s appears to have changed, at least when judged by comparing the actual short-term interest rate with the one predicted by the deviations of inflation rates from the target and output developments (the Taylor rule) (Box 6.1). Second, in small open economies, where monetary policy changes may induce sudden, unwanted movements in the exchange rate, and the euro area countries, stabilisation

by monetary policy alone may be insufficient, potentially calling for additional support from fiscal policy. Indeed, in the euro area countries, the monetary policy impulse from the common monetary policy cannot be guaranteed to be aligned with an individual country's stabilisation requirements.

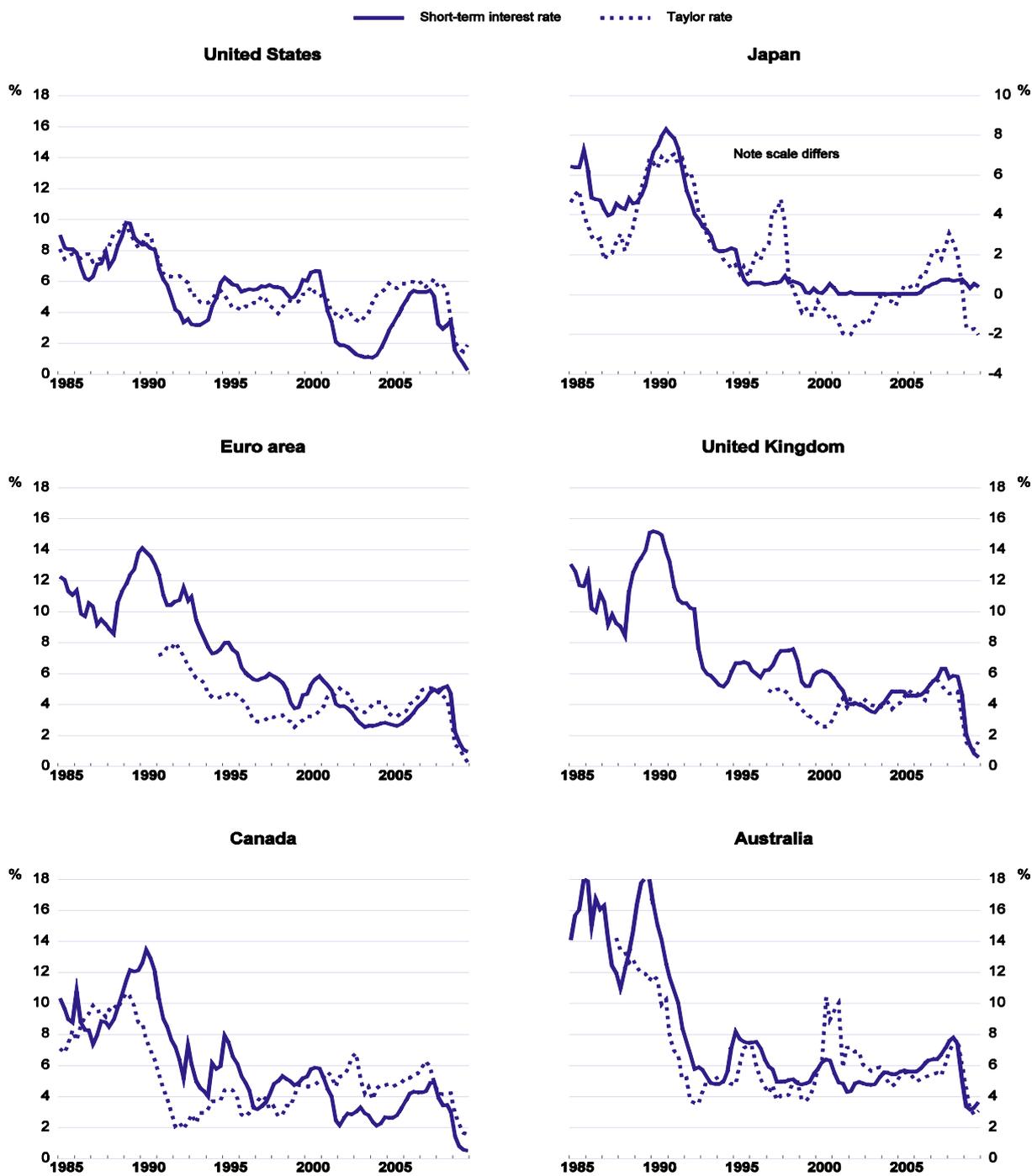
***... while fiscal policy cushions shocks via the automatic stabilisers***

Fiscal policy cushions shocks via the operation of the automatic stabilisers. For example, during a downturn unemployment benefits rise and tax revenues diminish. As a result, the size of the automatic stabilisers depends on a number of features of the tax and transfer system and is positively related to the size of government. While the automatic stabilisers have an important place in the policy arsenal they are difficult to optimise. Fiscal policy instruments that underpin the automatic stabilisers are usually designed in the first instance to cater for equity or efficiency objectives, with automatic stabilisation arising as a side-benefit. Adjusting them for the sake of stabilisation would need to be carefully balanced with the associated costs.

**Box 6.1. Taylor rules**

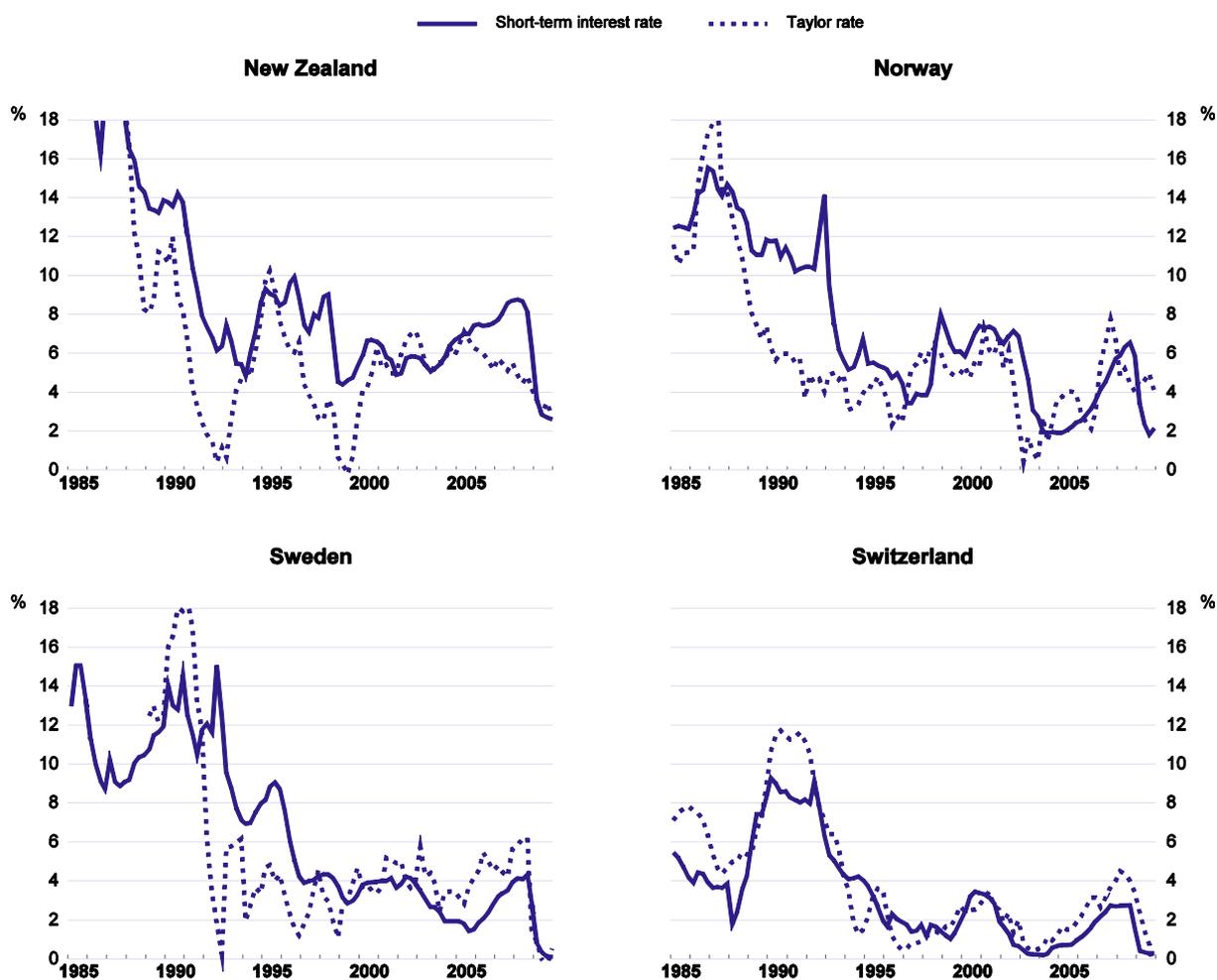
The so-called Taylor rule provides a simple metric to assess the conduct of monetary policy. The rule provides a formula to calculate a benchmark short-term policy interest rate, based on deviations of the actual inflation rate from the inflation target and the output gap and an interest rate that is appropriate when the economy is in balance (the so-called "neutral" or equilibrium real interest rate). For example, if inflation moved above target or the output gap turned positive, the short-term interest rate implied by the Taylor rule would become higher. Empirical evidence tends to suggest that monetary policy that is consistent with Taylor rules can contribute to stabilisation. In OECD countries, monetary policy has largely responded to inflation and output developments as the Taylor rule would predict, but there have been some large and persistent deviations (Ahrend *et al.*, 2008). The monetary policy stance in the United States and Canada, for instance, was relatively loose in the early to mid-2000s (see Figure). Varying the importance given to deviations from actual inflation and the output gap in deciding the appropriate interest rate can account for some of the differences between short-term interest rates and the Taylor rate, but not all. Another part of the deviations reflect the fact that Taylor rules using ex post data do not capture accurately the factors influencing monetary policy decisions. In particular, the information available at the time of making the decision is different and evaluations of pressures on inflation and output are not necessarily incorporated in contemporaneous measures of inflation and the output gap (Bernanke, 2010). Indeed when the forward-looking nature of monetary policy is taken into consideration explicitly, empirical analysis of interest rates suggests that even in the US and Canadian cases the so-called "Taylor principle" holds, with interest rates reacting more than proportionally to changes in the inflation rate. This is often seen as consistent with inflation stabilisation (Sutherland, 2010).

**Box 6.1. Taylor rules (continued)**  
**Taylor rules and actual short-term interest rates**



Source: OECD Economic Outlook 87 database.

Box 6.1. Taylor rules (continued)



Note: The Taylor rule rate is a function of an equilibrium real short-term interest rate, the output gap and the gap between actual inflation and the implicit inflation target. The standard specification, used here, is given by:  $r_T = \pi + r^* + \lambda_1(\pi - \pi^*) + \lambda_2GAP$ , where  $r_T$  is the Taylor rule interest rate,  $\pi$  the rate of inflation as measured by core CPI,  $\pi^*$  the inflation target,  $r^*$  the equilibrium real interest rate,  $GAP$  the output gap and  $\lambda_1$  and  $\lambda_2$  are the weights given to inflation and output stabilisation, respectively. The weights are both assumed to equal 0.5. The assumptions for the price stability target and equilibrium real interest rates follow Ahrend *et al.* (2008). For Japan, the assumed price stability target is for inflation of 1.0% and the assumed equilibrium real interest rate is 1.2%. For the euro area, the assumed price stability target is for inflation of 1.9% and the assumed equilibrium real interest rate is 2.1%. For United Kingdom, the assumed price stability target is for inflation of 2.0% and the assumed equilibrium real interest rate is 3.0%. For Canada, the assumed price stability target is for inflation of 2.0% and the assumed equilibrium real interest rate is 2.75%. For Australia, the assumed price stability target is for inflation of 2.5% and the assumed equilibrium real interest rate is 2.85%. For New Zealand, the assumed price stability target is for inflation of 2.0% and the assumed equilibrium real interest rate is 3.0%. For Norway, the assumed price stability target is for inflation of 2.0% and the assumed equilibrium real interest rate is 2.4%. For Sweden, the assumed price stability target is for inflation of 2.0% and the assumed equilibrium real interest rate is 2.1%. For Switzerland, the assumed price stability target is for inflation of 1.0% and the assumed equilibrium real interest rate is 1.6%.

Source: OECD Economic Outlook 87 database.

***Discretionary fiscal policy should mainly be used, when faced with a large shock***

When facing a large shock, fiscal policy can also help smooth activity through discretionary policy action, such as was the case with the fiscal packages introduced in most OECD countries during the recent crisis. This argument holds a fortiori in countries with weak automatic stabilisers and where leakage of a fiscal impulse through imports is limited, or when countries are hit simultaneously by a shock. Discretionary fiscal policy during a large and protracted shock may become more potent and can play a supporting role to monetary policy and the automatic stabilisers. In the absence of long-run solvency concerns, temporary discretionary fiscal policy responses to a large demand shock will boost aggregate demand, helping to narrow the output gap.<sup>2</sup> However, the ability of discretionary fiscal policy to affect economic activity depends on how private agents react (*e.g.* whether they save more as a result of a fiscal stimulus plan – see Box 1.6 in Chapter 1. New empirical work suggests that changes in current revenue are almost fully offset, whereas at least 50% of government spending is not offset. There is no offset for public investment, making it the most potent policy tool (Röhn, 2010). While the effectiveness of public investment is high there is a trade-off with how quickly it can be brought on stream. In particular, the complexities involved in large investment projects and the importance of contracts, which are time-consuming to negotiate, suggests that only “shovel ready” projects will meet both stabilisation needs and ensuring subsequent value for money. When long-run solvency concerns are more apparent, such as when government debt is high, the effectiveness of fiscal policy is reduced.<sup>3</sup>

***Discretionary fiscal policy may be less effective in normal times***

Discretionary fiscal policy operates by changing tax, benefit and spending policies and thereby creates greater uncertainties about the policy environment. They could have adverse effects on output over the medium term, though such effects would have to be set against the positive effects of stabilisation. At the same time, implementation may be slow and could result in a pro-cyclical rather than counter-cyclical fiscal impulse and political economy factors can hinder the withdrawal of stimulus. Furthermore, households and firms anticipating discretionary interventions could make the cycle more volatile. For example, firms and households may delay investment or car purchases as economies slow if they expect governments to grant support to investment or car purchases, such as “cash for clunkers”. For all these reasons, discretionary fiscal policy has not usually been seen as the stabilisation instrument of choice. On the other hand, discretionary policy may play a useful role, when monetary policy changes induce unwanted movements in the exchange rate. Furthermore, in

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2. The appropriate policy response to a supply shock is more difficult to determine than for a demand shock. First, a supply shock will also have implications for demand and the relative importance of the impact on the supply and demand side needs to be taken into account, when reacting to the shock. With temporary supply shocks, where the supply shock element predominates, a monetary policy response is often appropriate. With a more permanent supply shock, however, macroeconomic policy should at most attempt to smooth the necessary adjustment. In practice, differentiating between supply and demand shocks is often difficult.
  3. Results reported in Röhn (2010) suggest that the private saving offset becomes larger in EU countries when debt is greater than 75% of GDP.

the euro area, fiscal policy is the only national macroeconomic stabilisation tool for individual countries. Looking at past experience, estimates of discretionary fiscal policy show pronounced counter-cyclicality only in some countries (Australia, Canada, Denmark and the United States), while policy has been generally pro-cyclical in Austria, Belgium, Hungary, the Netherlands, Poland, Portugal and the United Kingdom (Égert, 2010a).

***Structural policies can influence leverage and resilience***

While structural policies are not primarily set to strengthen the resilience of an economy, they can directly and through their interaction with macroeconomic policies influence how shocks affect the economy. For example, reforms to housing and tax policies offer potential means to damp volatility:

- Supply-side restrictions in the housing market, such as strict zoning regulations, may reduce the volatility of the construction sector but tend to increase house price volatility (van den Noord, 2005).
- Tax incentives supporting homeownership, in particular mortgage interest rate deductibility, tend to raise the leverage of households, making them more vulnerable to shocks. Property taxes that are linked to current house price valuations, on the other hand, have some potential to stabilise the housing market.
- Tax policy that favours debt over equity financing provides incentives for increased leverage of firms making them and banks or other creditors more vulnerable to shocks. Indeed, higher debt-equity ratios tend to be associated with greater post-crisis output declines and larger cumulative output losses (Davis and Stone, 2004).

In general, policies and institutions that reduce labour and product market frictions may sharpen the initial impact of a shock but also reduce its persistence. For example, less stringent employment protection legislation may mean a large adjustment initially, but by reducing barriers to reallocation can help speed the adjustment to a permanent shock. On the other hand, some labour market policies that aim to keep people in employment, such as supporting short-term work, may limit the initial impact of a downturn by damping the decline in employment of permanent workers. However, such schemes can hinder adjustment thereafter, if they are maintained for too long (see Chapter 5).

**Uncertainty complicates policy**

***Uncertainty is pervasive requiring caution...***

Deciding the appropriate policy in the face of an economic disturbance is complicated by pervasive uncertainties. Uncertainties may concern the structure of the economy and the nature of the shocks hitting the economy as well as how policy choices affect the economy. In this context, exercising caution before committing to a policy may be beneficial, because waiting may reveal better or additional information

(Brainard, 1967). That said, if the costs of delaying a decision, such as removing stimulus, are large relative to the benefits of inaction, changes to policy should be made much more rapidly than implied by the Brainard principle. More generally, the decision-making process should give less weight to information that is more uncertain. In addition, policies that are more easily reversible may be more appropriate in such circumstances.

*... or greater prudence*

While waiting for additional information before committing to a particular policy is one approach to dealing with uncertainty (the so-called Brainard principle), another is to assume the worst. In this approach, the choice of policy should consider the expected effect under different assumptions about shocks (*e.g.* the size and type of different shocks, such as commodity price hikes) and how the economy works (*e.g.* different types of models can capture different aspects of the economy better). The preferred policy may switch from the best choice when there is little uncertainty to policies that entail less welfare during normal times, but do reasonably well under catastrophic, but rare, events or if the economy works in a different manner than is anticipated.

*Uncertainty arises due to measurement problems*

Assessing the current state of the economy correctly and understanding the shocks hitting the economy and their propagation is a major source of uncertainty. A critical issue is the timeliness and accuracy of data, which are often only available with a considerable lag and subject to revision (Koske and Pain, 2008). The position of the economy in the cycle and the lags in observing the effect of shocks on the economy can interact to create considerable uncertainty. For example, measuring the output gap is a considerable challenge for several years after a major shock, such as that produced by the recent financial and economic crisis.

*Uncertainty creates problems for monetary policy...*

Uncertainties about the state of the economy are important for monetary policy. For example, in planning exit strategies from the current exceptionally supportive monetary stance, the nature of the uncertainty could influence the appropriate approach. If there is greater uncertainty about the size of the output gap than the rate at which it is closing (*e.g.* growth is firmly expected to strengthen in the near future), monetary policy may begin to tighten gradually. On the other hand, if there is less uncertainty about the size of the output gap, but the prospects for growth are highly uncertain, monetary policy may delay the tightening, but tighten rapidly when growth picks up.

*... and fiscal policy*

Difficulties in measuring the true, underlying fiscal position can introduce uncertainty for fiscal policy. For example, the estimated size of the output gap determines the size of the cyclical adjustment of fiscal balances. Uncertainty about the output gap thereby carries over to the estimates of the underlying fiscal position. In addition, more accurate information on the influence of cyclical movements of asset prices on government revenues would give a better understanding of underlying fiscal positions. Conventional measures of cyclically-adjusted balances, by failing to take the impact of asset prices into account, painted too rosy a picture of underlying budget balances during the upswing prior to the economic and financial crisis.

***Detecting and addressing asset price misalignments is a particular problem...***

Current methods to detect asset price misalignments are still insufficiently robust to be a reliable guide for policy. Empirical attempts to identify emerging asset price misalignments are prone to sounding false alarms; and the ratio of false alarms to correct predictions can be high, implying costs if monetary authorities reacted systematically to such alarms.<sup>4</sup> Even in well-specified models, as many as one-third of all warnings can be false when predicting two-thirds of the unsustainable asset price booms correctly (Crespo Cuaresma, 2010). However, given the importance of accurate detection, devoting resources to developing robust risk assessment tools, such as additional early warning systems, is warranted.

***... that creates challenges for monetary policy...***

Without strong guidance about the likely direction of asset price movements, monetary policy should adopt a precautionary approach of guarding against an unnecessarily lax monetary policy stance that may stoke misalignments as well as being prepared to deal with the aftermath of a bubble bursting. That said, detecting large asset price misalignments is feasible (van den Noord, 2006) and this is particularly the case when exuberant credit growth is fuelling excessive asset price increases, a constellation that tends to incur higher economic costs when the bubble bursts. Thus, in light of the costs of the recent crisis, monetary policy may need to consider acting in such circumstances if micro and macro-prudential policies are insufficiently robust (see below). In particular, monetary policy should consider increasing interest rates and “leaning against the wind”. The need to avoid destabilising the economy and to maintain the anchoring of inflation expectations nonetheless constrains such “leaning”, which may be particularly circumscribed in small open economies.

***... and may require a better articulation of the respective roles of financial regulators and monetary authorities***

The recent financial crisis has made clear that lack of coordination between monetary and regulatory authorities has been one element that favoured the emergence of domestic imbalances and the build-up of macro-financial risks. When addressing this defect, a fundamental choice arises between expanding the mandate of central banks to include financial stability or assigning it to a different institution so that each agency has one objective and one main instrument. As economies are affected by multiple shocks, an advantage of a single institution is that it can set an optimal policy response by articulating a balance among several policy objectives and instruments, accounting for interdependencies among tools and reflecting the relative importance of different shocks. Having separate authorities each with its area of responsibility and its instrument, on the other hand, would offer greater accountability, because objectives and mandates are clearly assigned so that performance can be more easily monitored insofar as each authority’s objective is not influenced too much by the instruments set by the other authority. If this set-up were to emerge as the preferred framework, a coordination mechanism between the central bank and the regulatory authorities would be needed to identify the

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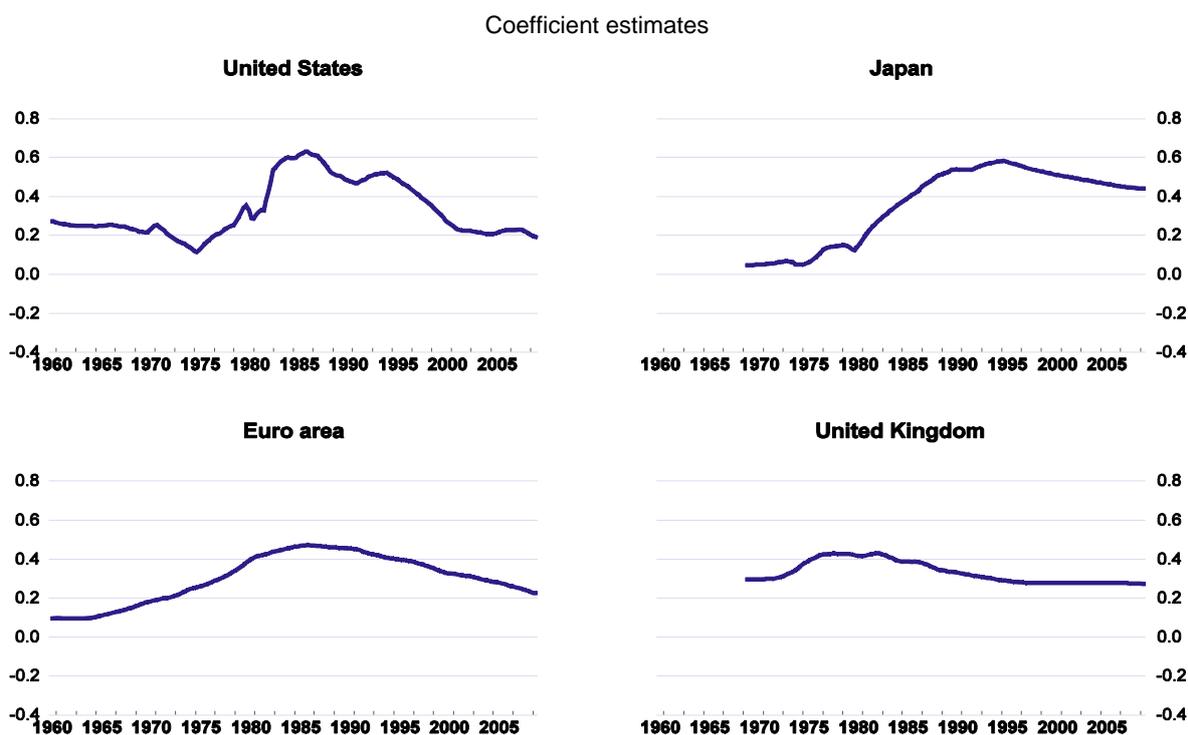
4. Reacting to false alarms about turning points can imply large welfare costs as some misalignments correct themselves without any major repercussions for the economy. Furthermore, the warning can come too late so that a policy response could aggravate the downturn.

build-up of systemic risks and in deciding the best response to mitigate them.

***Uncertainty also arises in gauging how the economy will react to monetary policy...***

Uncertainty about how strongly monetary policy affected activity and inflation (the “transmission mechanism”) and how other determinants of overall financial conditions were changing complicated monetary policy in the lead-up to the crisis. Financial market developments and greater international linkages have made monetary policy transmission more capricious, creating challenges in determining the strength and speed of the required monetary policy impulses. Indeed, the impact of changes of the short-term interest rate on long-term rates appears to have changed over time in some countries, particularly the United States (Figure 6.3). Judging the required monetary policy impulse is also complicated by movements in other determinants of financial market conditions such as long-term interest rates, credit conditions, exchange rate movements and asset-price related wealth effects which can offset or amplify the intended policy impulse. For instance, the mismatch between saving and investment opportunities at the global level have helped keep long-term interest rates low in countries with a low saving rate, while pushing up asset prices, so that, despite the monetary policy tightening before the economic crisis, financial conditions remained loose for some time.

**Figure 6.3. Response of long-term to short-term interest rates**



Note: The coefficients for the response of the long to the short rates are taken from time-varying estimates. These are updated estimates based on Cournède *et al.* (2008).  
Source: OECD Economic Outlook 87 database.

***... and fiscal policy***

The impact of fiscal policy on the economy is also uncertain. Fiscal policy multipliers (the impact of fiscal stimulus on economic activity) can

vary significantly not only reflecting the choice of fiscal instrument (e.g. spending or tax cuts) but also due to the state and openness of the economy. The size of multipliers can be greater if there is more slack in the economy and if the financial sector is impaired. When the financial sector is impaired the effect of fiscal policy may be greater as households may spend more of the fiscal stimulus than would be the case if households did not face borrowing constraints. As mentioned above, households may offset part of a fiscal policy change by their saving behaviour and such reactions may change in magnitude over time, reflecting, for example, the underlying fiscal situation. Moreover, if fiscal expansion drives up domestic interest rates, capital inflows may rise, leading to an appreciation of the exchange rate. In addition, spillover effects from fiscal policy in other economies can have considerable impacts, such that simultaneous fiscal impulses in several countries may have a larger impact than a fiscal stimulus in each country on its own.

### **Prudence and building in wider safety margins**

*Recent experience suggests greater safety margins are needed*

An important lesson from the severity of the recent recession is that policy in various areas will have to be more prudent during upswings and to build in greater safety margins to be able to react to large adverse shocks.

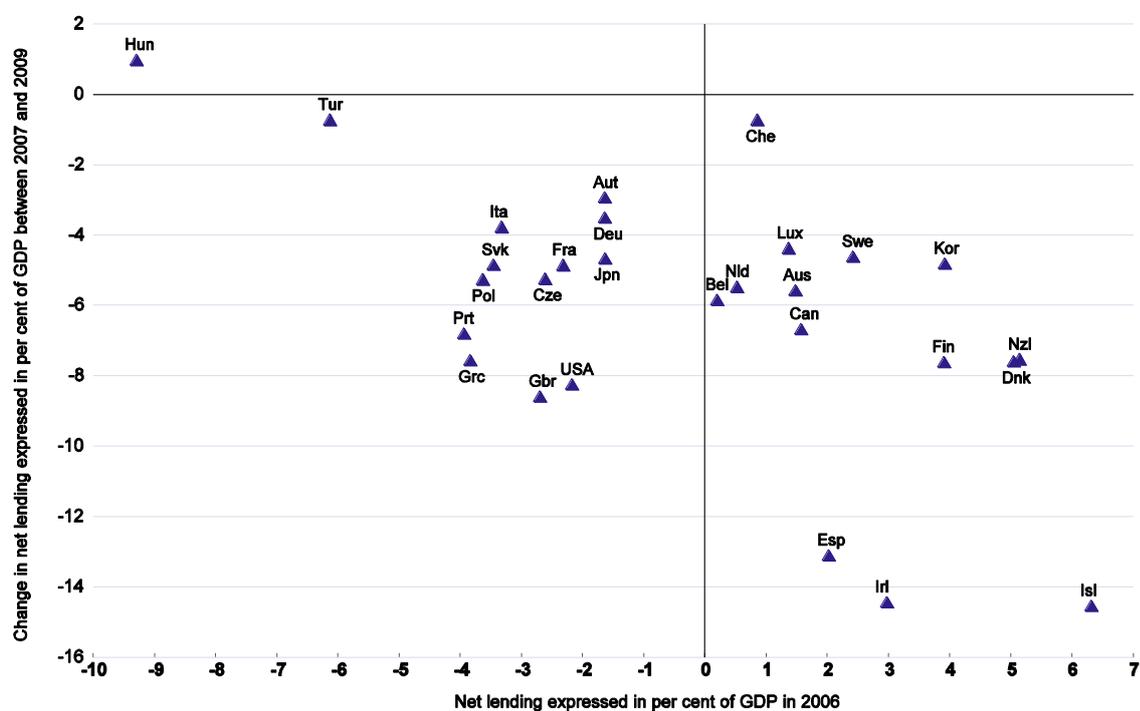
*Fiscal policy was poorly prepared to deal with the crisis...*

The use of discretionary fiscal policy is constrained in countries with weaker fiscal positions. For example, fiscal policy in countries running large deficits is typically less responsive in a downturn than in countries running small deficits or surpluses (Égert, 2010a). Against this background, cushions for fiscal policy were clearly too small before the recent crisis in many countries. As a result some countries, where the fiscal position was already in a bad shape, were forced into a pro-cyclical tightening during the crisis, while countries with a comfortable budget surplus could implement a larger fiscal stimulus as compared to countries with a relatively high deficit (Figure 6.4). These experiences raise the issue whether wider safety margins are needed.<sup>5</sup>

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5. The issue of appropriate safety margins for fiscal policy has been analysed in the context of the Stability and Growth Pact requirements in the European Union. For example, Dalsgaard and de Serres (1999) estimated that governments maintaining budgets close to balance would have a 90% probability of being able to allow the automatic stabilisers to operate freely without breaching the 3% deficit limit when faced by shocks calibrated on historical experience. Codogno and Nucci (2008) re-examined the necessary safety margins and found that in countries where output gaps were very volatile larger safety margins would be needed.

Figure 6.4. Fiscal positions on the eve of the downturn and subsequent loosening



Source: OECD Economic Outlook 87 database.

### *... and needs to be strengthened*

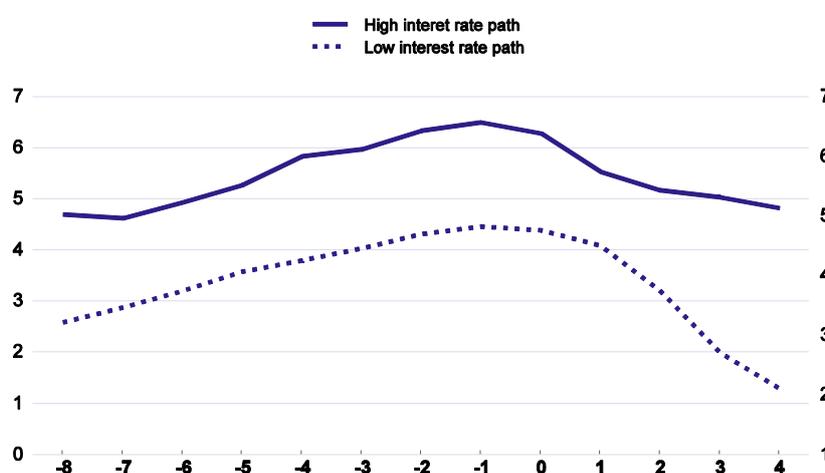
The framework for fiscal policy can be strengthened in various ways. First, well-designed fiscal rules can help fiscal policy being counter-cyclical during the expansion phase of the cycle, and thus allow a stronger response to cope with large adverse shocks. For example, empirical evidence suggests that budget balance rules accompanied by spending rules are more effective in securing fiscal consolidation (Guichard *et al.*, 2007). But inappropriate fiscal rules can be destabilising, such as simple balanced-budget rules that force governments to cut spending when revenue falls during a downturn (as occurred in many US states), and fiscal rules may also lead to behaviour aimed at respecting the letter but not the spirit of the rule (Koen and van den Noord, 2005).

### *Monetary policy and the zero bound: there are pros and cons to raising the inflation target*

Monetary policy can react forcefully to large adverse shocks when inflation expectations are well anchored and the room for manoeuvre is not constrained. Past experience suggests that short-term interest rates fall by around 3 percentage points in the four to five quarters following the start of a recession. During the crisis, the central banks that had been successful in anchoring inflation expectations at a low level were able to take vigorous action (Figure 6.5). However, there are limits to how far interest rates can fall. A large adverse shock can raise the spectre of deflation and cause the zero bound for interest rates to become binding. Positive inflation targets provide a safety margin to avoid this outcome. A survey of a number of

studies that examined different inflation targets found that an inflation target of around 2% entails only a small risk of hitting the zero bound and a very small risk of tipping the economy into a deflationary spiral (Yates, 2004). Nonetheless, the crisis has shown that hitting the zero bound is not just a theoretical possibility. However, monetary policy did not become completely ineffective in the recent crisis; rather it relied on non-conventional tools albeit with greater uncertainty about their effects. While in principle recent events might call for a re-examination of the inflation target, for which a number of arguments can be made both for and against (Blanchard *et al.*, 2010),<sup>6</sup> the need to avoid destabilising inflation expectations at a moment of record government borrowing suggests not tampering for the time being.<sup>7</sup>

Figure 6.5 Short-term interest rates around the last turning point



Note: The evolution of short-term interest rates just prior to and after the economy entered recession are displayed in the figure. The high and low interest rate paths are the upper and lower quintile of the observations for all OECD countries. During this downturn policy rates fell more quickly than the short-term interest rates displayed in the figure.

Source: OECD Economic Outlook 87 Database.

### ***Stabilisation can be challenging in small,***

The difficulties facing stabilisation policy are more severe in small, open economies. Monetary policy that affects the exchange rate may be a

6. For example, higher inflation targets may be justified if the economy faces larger shocks than before. However, higher inflation rates may lead to efficiency losses and induce greater inflation volatility.
7. Targeting a price-level rather than an inflation rate could provide another way to reduce the risk of hitting the zero bound, at least theoretically. If the price level undershoots the target, higher inflation will be expected, lowering long-term real interest rates, thereby supporting activity and pushing up prices. This reduces the need for large shifts in policy rates and may reduce the probability of hitting the zero bound (Ambler, 2009 and Cournède and Moccerro, 2009). However, successful price level targeting is predicated on a sufficient degree of forward-looking behaviour and the self-regulating capacity of price-level targeting hinges on a high degree of monetary policy credibility. At the same time, price-level targeting would entail a number of practical difficulties. A related possibility is Svensson's (2003) "foolproof" approach, which combines a commitment to a higher future price level, concrete action to show commitment to this price level and an exit strategy that specifies how to return to "normal".

*open economies*

potent stabilisation instrument, but at the price of leading to resource shifts between the open and sheltered sectors.<sup>8</sup> Exchange rate interventions can potentially offset some of these impacts, though such actions would need to rest on an assessment of misalignments, which are difficult to identify. As a result, when monetary policy changes induce unwanted exchange rate movements, stabilisation policy requires relatively more support from fiscal policy. However, the effectiveness of fiscal policy is also limited, not least because stimulus leaks abroad through higher imports. In this light, fiscal safety margins need to be significantly larger to assist stabilisation in a small, open economy.

*Financial policies should aim to provide larger buffers,...*

In the financial sector, policy settings need to be reconfigured to damp unnecessary volatility and ensure robust micro-prudential regulation. Indeed, the differing experiences of countries in the recent crisis suggest that robust micro-prudential regulation can help shield the financial sector from the worst effects, which has been the case in Canada, a country with low interest rates in the build-up to the crisis.<sup>9</sup> There are several ways to reduce the pro-cyclicality of the financial system. These include raising its shock-absorption capacity by aiming at higher, counter-cyclical and possibly contingent capital buffers and implementing a system of provisioning for bad loans that provides sufficient buffers during a downturn. It will also be important to deal with incentive problems embedded in the structure of financial institutions and remuneration systems and to deal with moral hazard problems for systemically important financial institutions that are deemed too important to fail. Recent international initiatives suggest ways to reduce the pro-cyclicality of the financial system by raising its shock absorption capacity and dealing with incentive problems.

*... targeted interventions should be considered...*

There are a number of instruments that have a strong and direct impact on credit growth and can target particularly vulnerable sectors. Credit booms are often characterised by a shift into riskier forms of lending.<sup>10</sup> In this light, risk weights attached to such lending categories could be changed when setting banks' required capital, while varying margin requirements could be an appropriate instrument for dealing with vulnerabilities building up in capital markets. Other potential tools include dynamic loan loss provisioning and capital surcharges on top of prevailing micro-prudential

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8. For example, in New Zealand, monetary policy tightening largely due to concerns about asset price developments, particularly for housing, stimulated further capital inflows (OECD, 2009). As a result, long-term interest rates barely budged, damping the intended effect on domestic demand. In these conditions, the appreciation of the exchange rate hurt principally the tradeable sector, weakening the economy in advance of the financial crisis.
  9. This is also arguably the case in Spain, where the large banks have withstood relatively well a substantial correction in house prices and downturn in the economy.
  10. Pro-cyclical credit market developments, which may support the development of large asset price misalignments, can arise due to changes in balance sheets. For example, healthier balance sheets of lenders offer greater collateral and lenders may then be more willing to grant credit. Healthier bank balance sheets may relax the constraints of capital adequacy requirements (which limit the amount of loans relative to bank capital), thereby allowing banks to extend more credit (Bernanke and Gertler, 1995; Bernanke and Blinder, 1988).

capital ratios.<sup>11</sup> Tools specific to housing include capping loan-to-value ratios in mortgage lending and loan servicing costs relative to income as well as limiting the use of exotic mortgage products. Though appealing in theory, all these potential measures have plenty of practical implementation difficulties. Relevant issues include which indicators to consider when setting these policy instruments and how to calibrate the response. Another issue is whether the measures should obey a simple rule, or whether more discretion should be allowed for.<sup>12</sup>

***... and systemic risks  
need to be tackled***

The financial crisis has highlighted that the current regulatory and supervisory focus on individual institutions may not sufficiently take into account systemic risks (Borio *et al.*, 2001). One of the factors contributing to the severity of the current crisis is how strongly financial sectors were exposed to systemic risk. In part this was due to financial institutions becoming highly leveraged and interconnected. Furthermore the international transmission of financial shocks has become arguably faster and the inter-linkages stronger (Trichet, 2009). In this context, international co-ordination in reforming prudential policies may be beneficial in ensuring that there is a level playing field and fewer opportunities for regulatory arbitrage.

***Macro prudential  
oversight should focus on  
the building up of  
vulnerabilities...***

Developing macro-prudential regulation to improve the robustness of financial institutions to shocks originating both domestically and abroad could be a useful complement. Adding an overarching layer of macro-prudential oversight to micro-prudential supervision of the financial system would provide a more comprehensive view of the building-up of vulnerabilities. Better macro-prudential oversight would draw different sets of policy makers together and foster a better dialogue between monetary policy makers, regulators and supervisors with a shared macro-prudential focus.

***... such as credit-driven  
asset price booms***

In such a framework, different elements could provide several lines of defence to credit and asset prices developments that are accompanied by increasing leverage. In the first line of defence, stronger micro-prudential regulation should help financial sectors reduce their exposure to unwarranted risks and withstand adverse shocks. Secondly, as macro-prudential alarms are raised more targeted interventions, such as limits on loan-to-value ratios in the housing market can help prevent credit growth and asset price developments from getting out of hand. Finally, when financial sector regulation proves insufficient to damp credit and asset price developments, a macro-prudential assessment may conclude that there is a role for monetary policy to lean against the wind.

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11. On capital surcharges see Bank of England (2009).

12. In this respect, given the complexity of the issue, it seems unavoidable that some judgment will be needed in setting policy tools in accordance with both macroeconomic and financial variables.

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