How have we handled the economic crisis and what do we do now?

2009 Félix Neubergh Lecture

Gothenburg, 8 December

Structure of the lecture

- The character of the crisis
- The handling of the crisis
- What now?

  - short-run exit

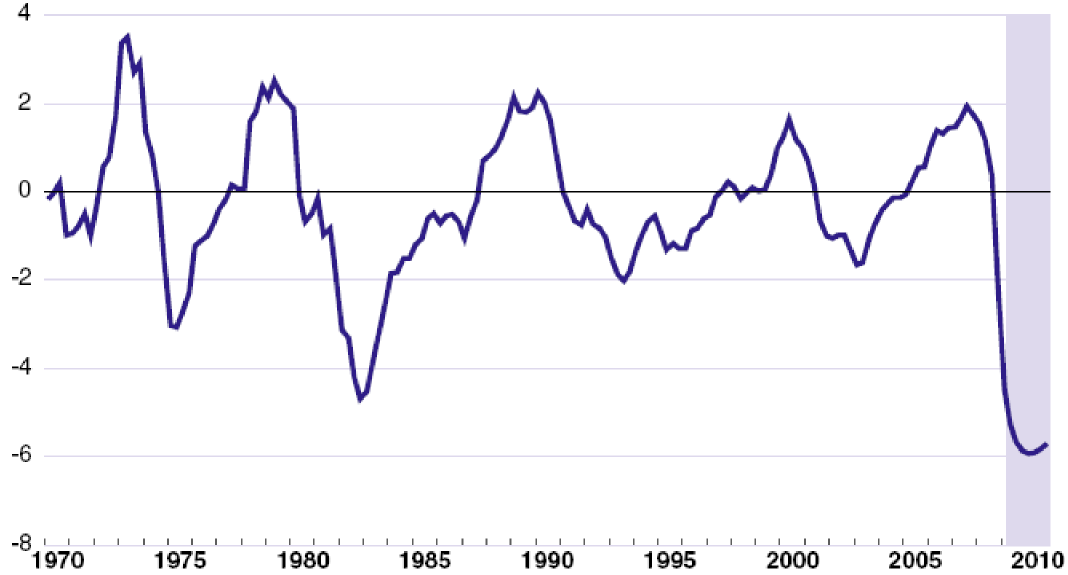
  - long-run system changes

The character of the crisis

- What looked like an ordinary downturn in the US turned into a full-blown financial and economic crisis
  - falling house prices and subprime loan crisis
  - transmission to the global financial system
  - explosion of interest rate spreads
  - cessation of interbank lending
  - deleveraging and credit contraction
- World economic recession
  - large negative GDP gap for the whole OECD area
  - large contraction of world trade

Figure 1.16. **The OECD output gap will be the largest in four decades**

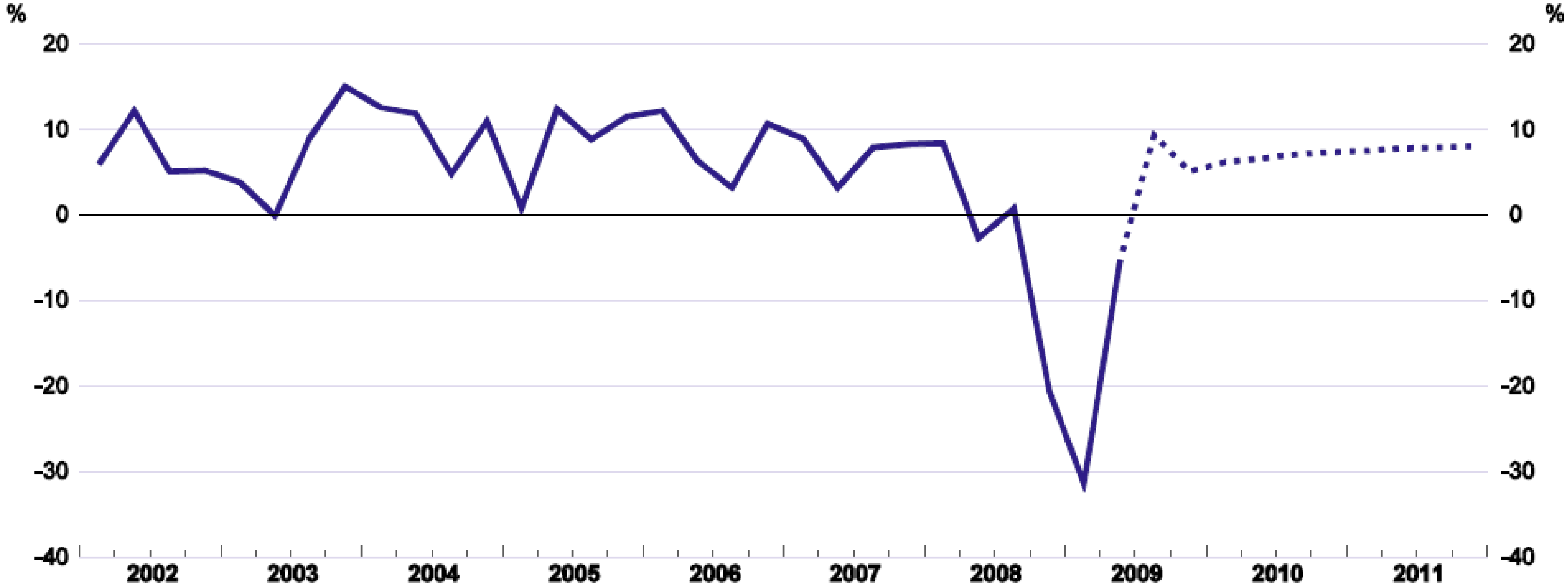
In percentage of potential output



Source: OECD Economic Outlook 85 database.

Figure 1.7. World trade growth is now rebounding

Quarterly annualised growth rate



Source: OECD Economic Outlook 86 database.

Three lines of defence

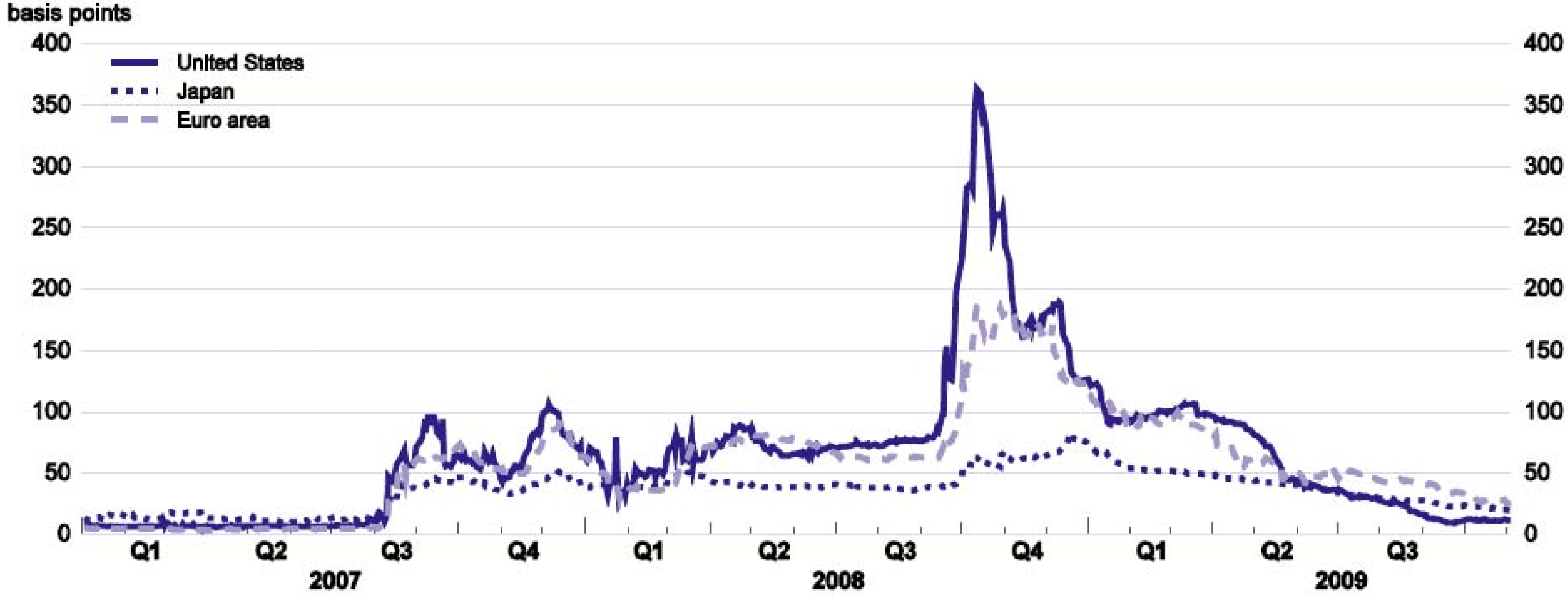
1. Emergency measures to deal with the financial turmoil
2. Monetary policy
3. Fiscal policy

Emergency measures to deal with the financial crisis

- Liquidity provision and crisis loans from central banks
- Government support for bank take-overs
- Government take-overs of insolvent banks
- Higher deposit insurance
- Government guarantees of bank lending
- Government capital injections
- Government bail-outs
  - ring-fencing
  - purchases of toxic assets
- **Once governments reacted they did so with impressive speed**

Figure 1.2. Money market conditions have improved remarkably

Three-month spreads, last observation: 2 November 2009

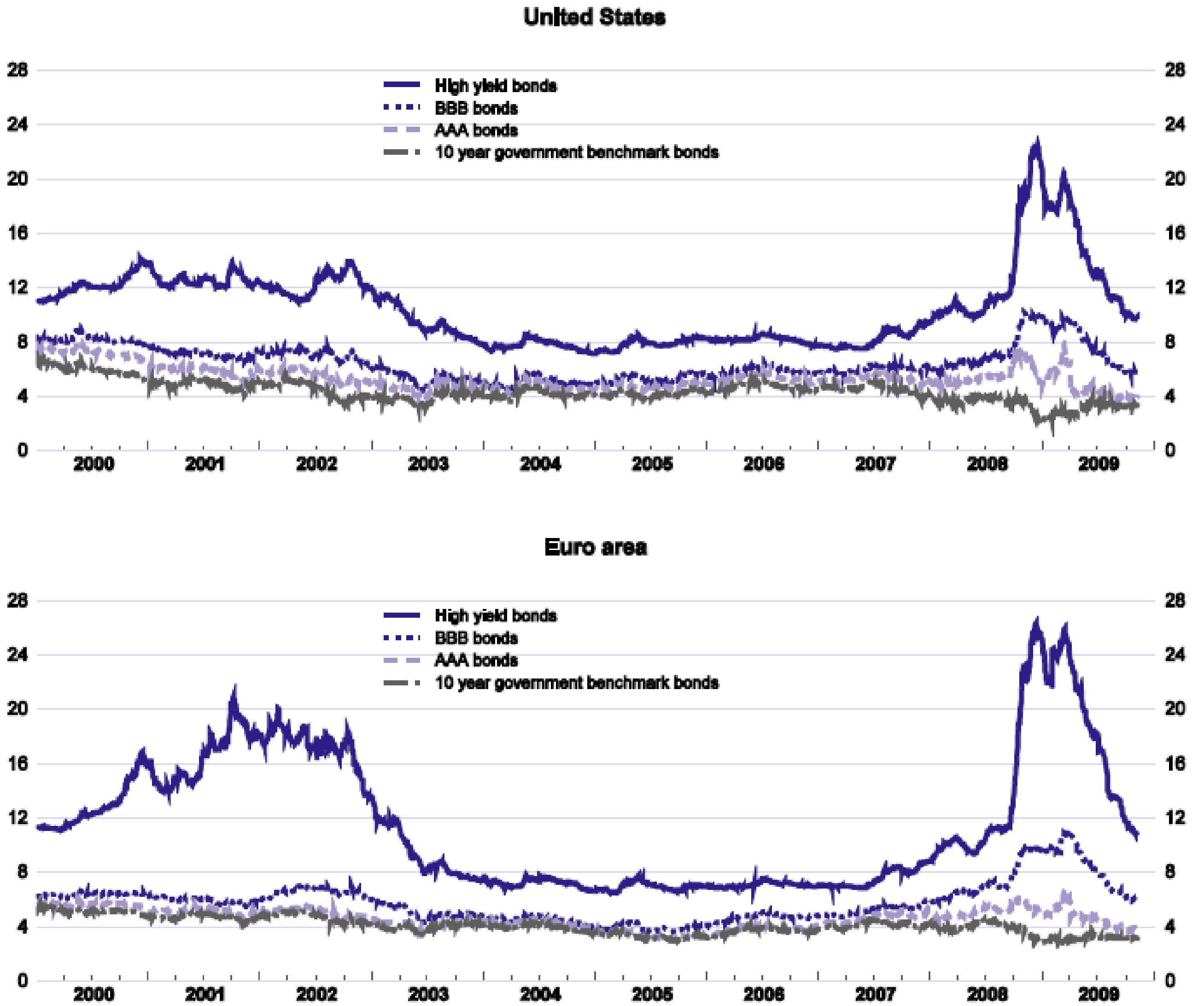


Note: Spread between three-month EURIBOR and EONIA swap index for euro area; spread between three-month LIBOR and overnight indexed swap for the United States and Japan.

Source: Datastream and Bloomberg.

Figure 1.4. Corporate bond yields have declined considerably

Per cent, last observation: 4 November 2009

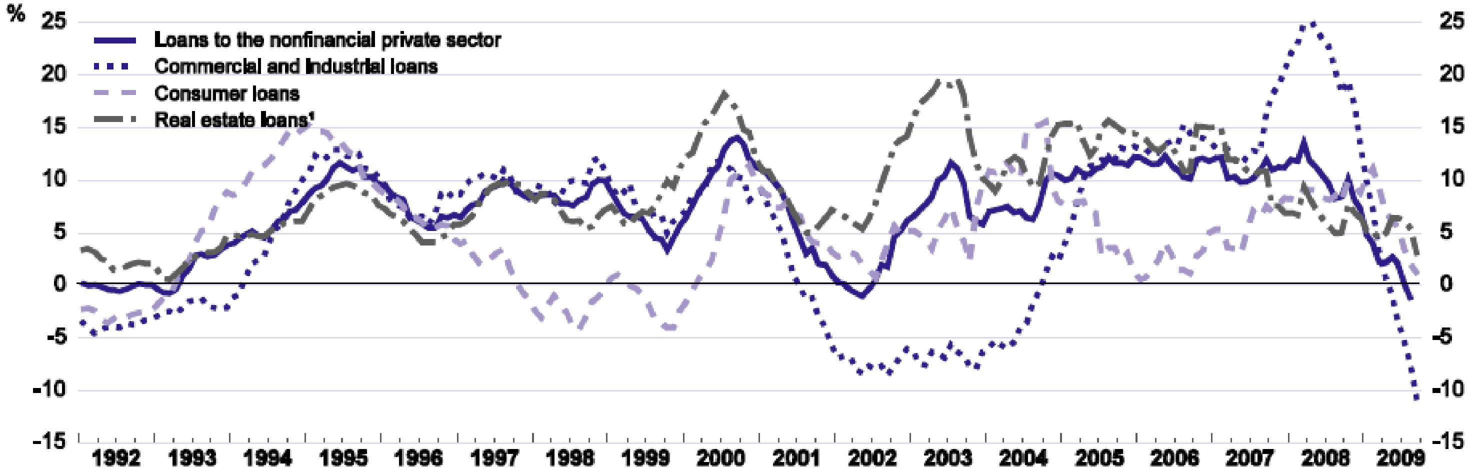


Source: Datastream; Merrill Lynch; IBOXX.

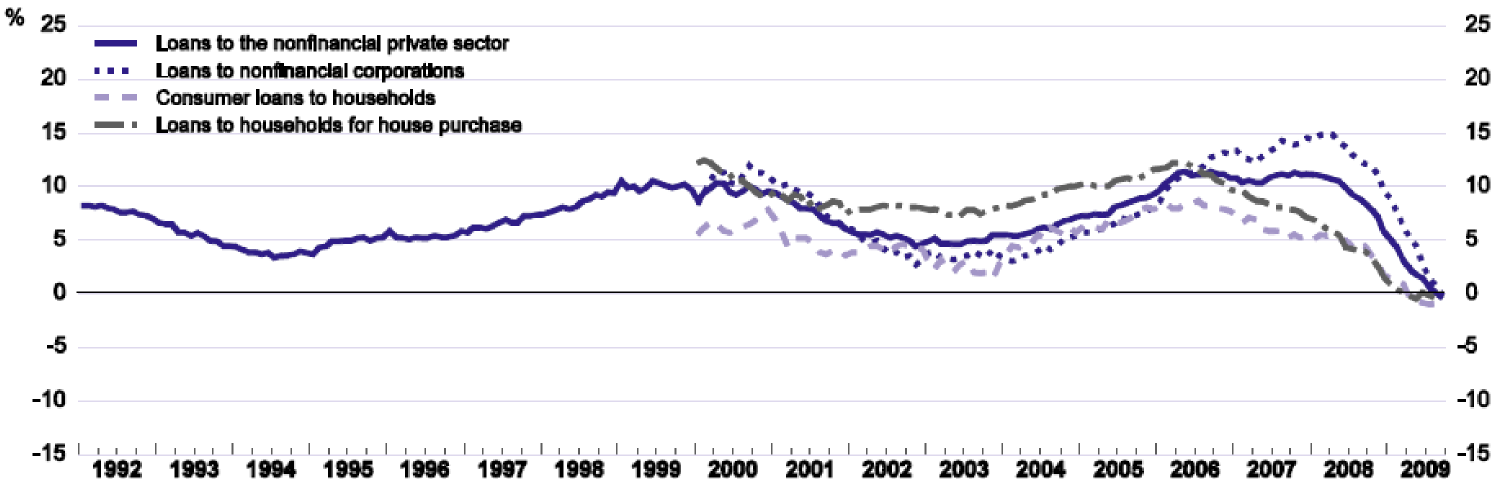
Figure 1.3. Bank lending growth has collapsed

Year-on-year growth rate

United States



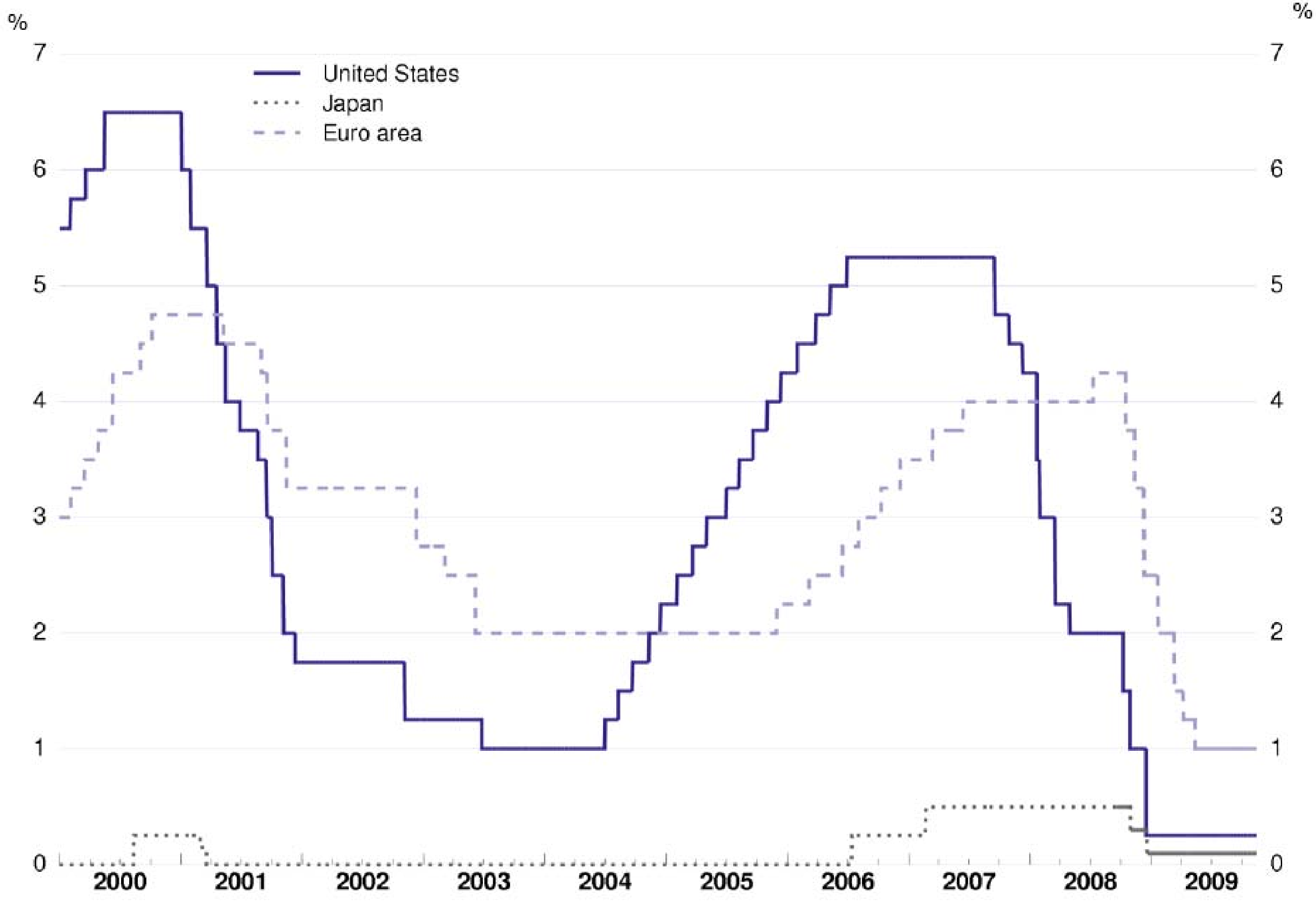
Euro area



Monetary policy

- Fast cuts of central bank policy rates worldwide
- Resort to unconventional measures (quantitative easing)
- On the whole swifter monetary policy response than could be expected

Monetary policy rates have remained at a low level

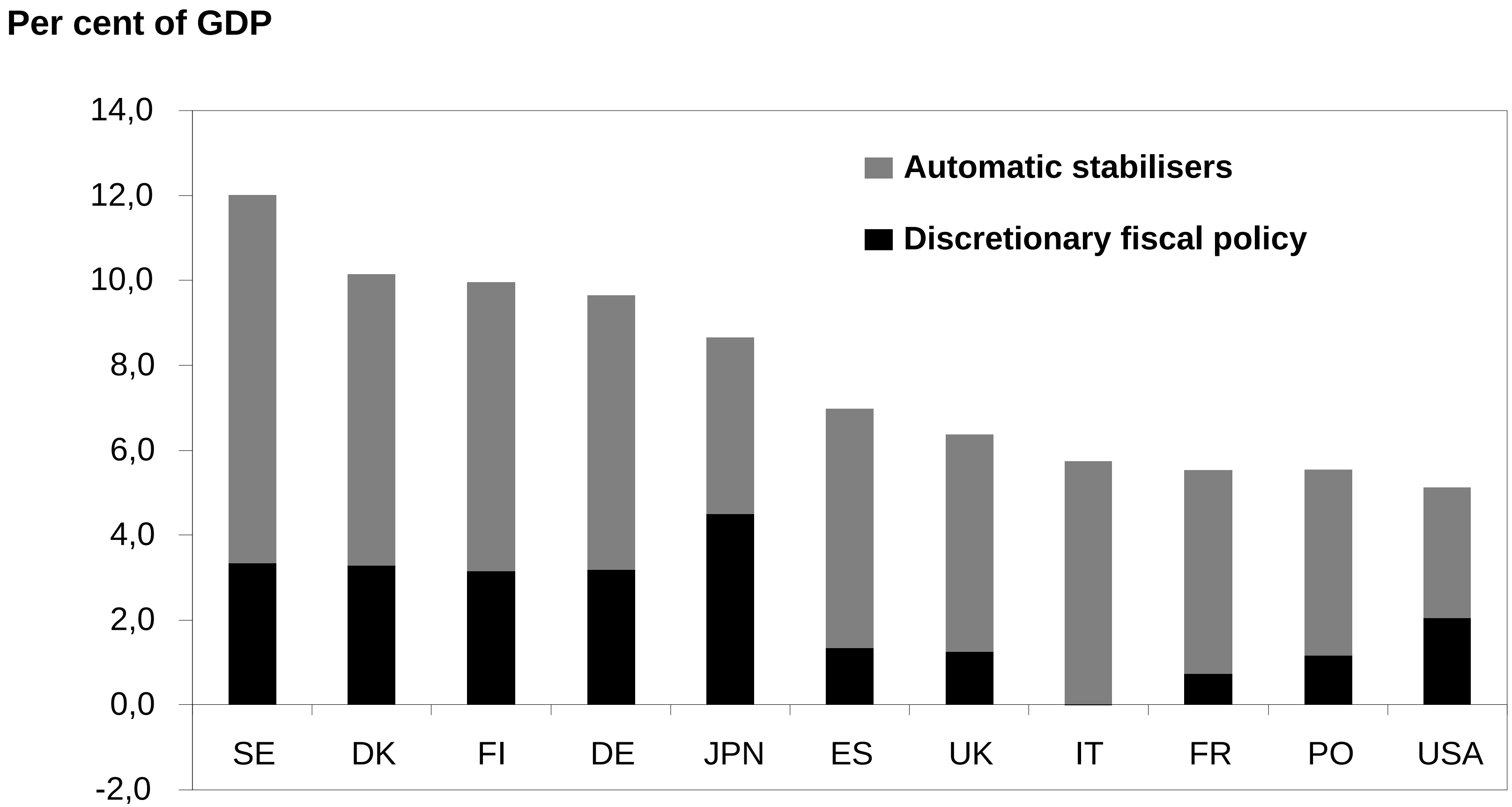


Source: Federal Reserve, Bank of Japan, European Central Bank.

The conventional wisdom: avoid discretionary (activist) fiscal policy

- Long decisions lags
- Risks of political misuse
  - political business cycles
  - deficit bias
- Fiscal policy may be ineffective
  - Ricardian equivalence
  - offsetting rises in long-term interest rates
- Countercyclical policy should rely primarily on monetary policy and the automatic stabilisers in fiscal policy
- These conventional principles were swiftly abandoned in the extraordinary situation that arose
  - reliance on both automatic stabilisers and discretionary measures
  - measures on both the expenditure and the tax side

Size of the fiscal stimulus packages and automatic stabilisers 2009 and 2010



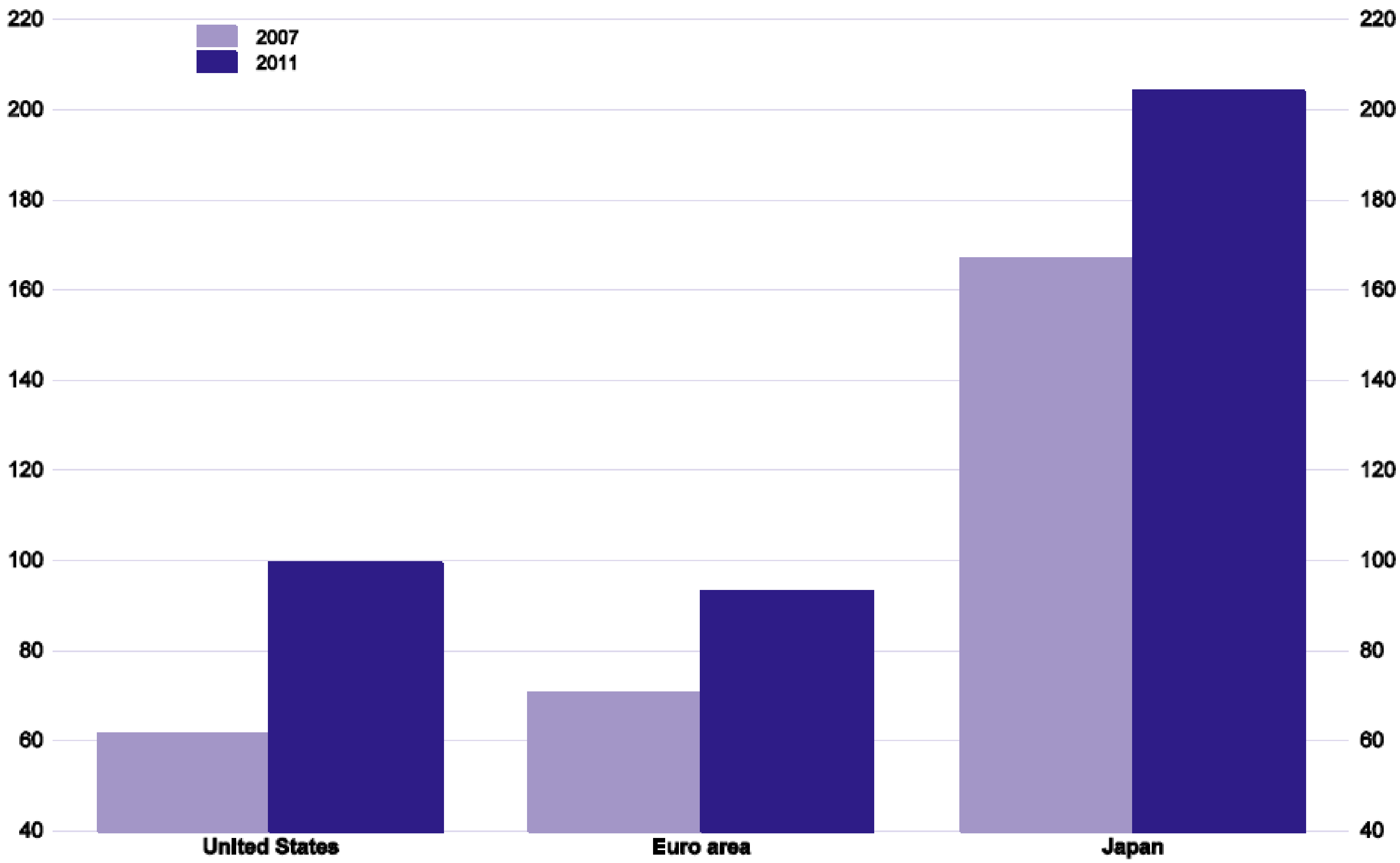
Source: OECD Economic Outlook June 2009

Fiscal balance

	2009	**2010**
Denmark	-2.5	-5.4
Finland	-2.3	-4.8
Greece	**-12.7**	**-9.8**
Iceland	**-15.7**	**-10.1**
Ireland	**-12.2**	**-12.2**
Italy	-5.5	-5.4
Japan	-7.4	-8.2
Spain	**-9.6**	**-8.5**
Sweden	**-2.0**	**-3.0**
United Kingdom	**-12.6**	**-13.3**
United States	**-11.2**	**-10.7**
Euro area	-6.1	-6.7
Total OECD	-8.2	-8.3

Government debt levels are being pushed to record highs

In per cent of nominal GDP



Source: OECD Economic Outlook 86 database.

Long-run sustainability of fiscal policy

- **The intertemporal budget constraint**: future primary surpluses must be at least as large as the current debt

- **The S2-indicator**:

  - the **permanent** increase in tax revenues (or reductions in government expenditures) in percent of GDP required for meeting the intertemporal budget constraint

The S2-indicator on fiscal sustainability

Belgium	5.3
Denmark	-0.2
Estonia	1.0
France	5.6
Germany	4.2
Greece	**14.1**
Ireland	**15.0**
Italy	1.4
Latvia	**9.9**
Lithuania	7.1
Netherlands	6.9
Spain	11.8
Sweden	1.8
United Kingdom	**12.4**
Euro area	**5.8**
EU27	**6.5**

The sustainability problem

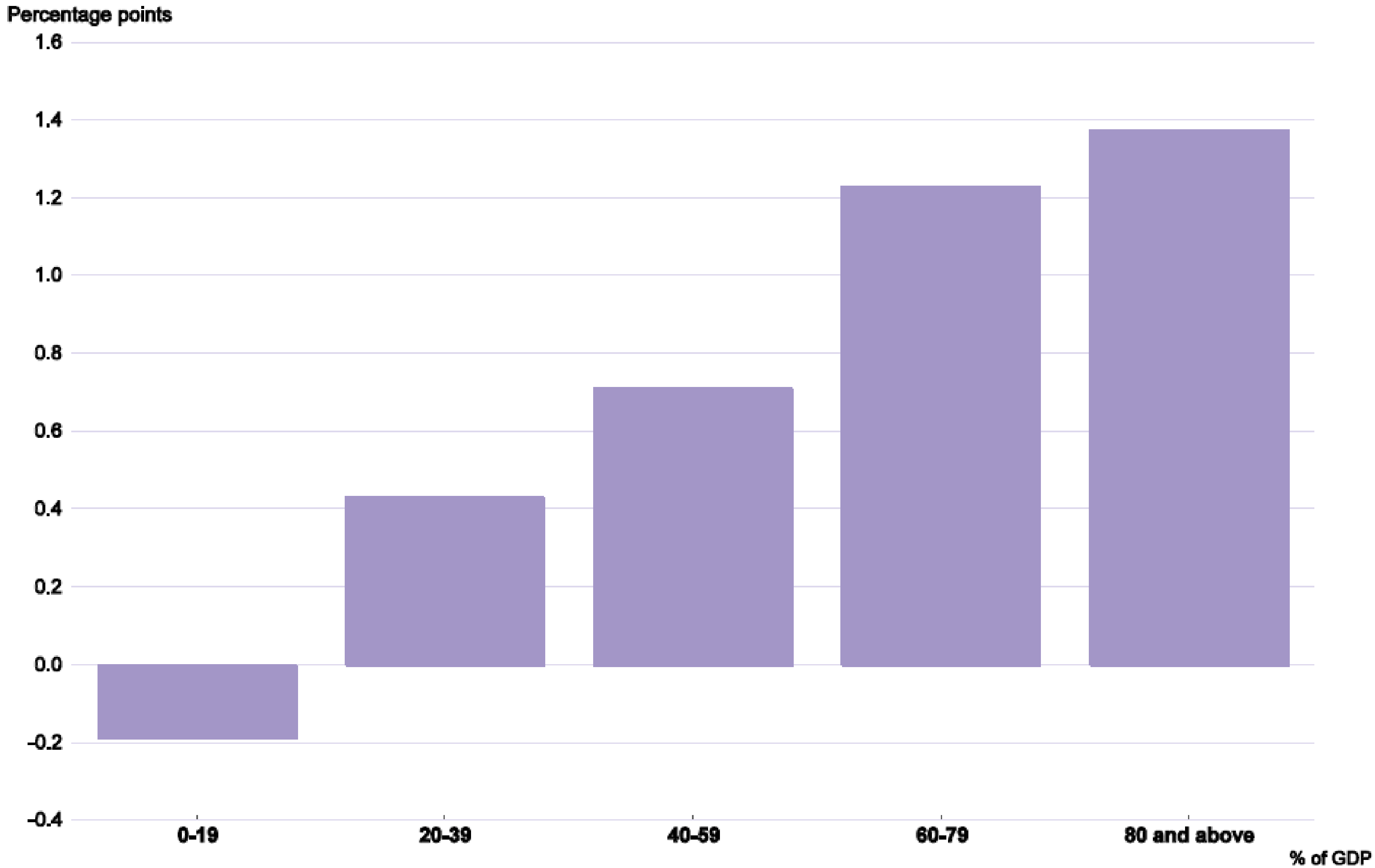
- Demographic pressures from an ageing population
- The fiscal deficits in the crisis come on top of the demographic problems
- Sustainability problems may reduce the effectiveness of short-run fiscal stimuli

  - interest rate rises because of higher risk premia

  - high debt/high deficits raise the probability of tax rises/transfer reductions in the near future which tends to reduce private consumption already now

Higher government debt tends to raise long-term interest rates

Spread between long-term and short-term interest rates versus gross government debt in % of GDP

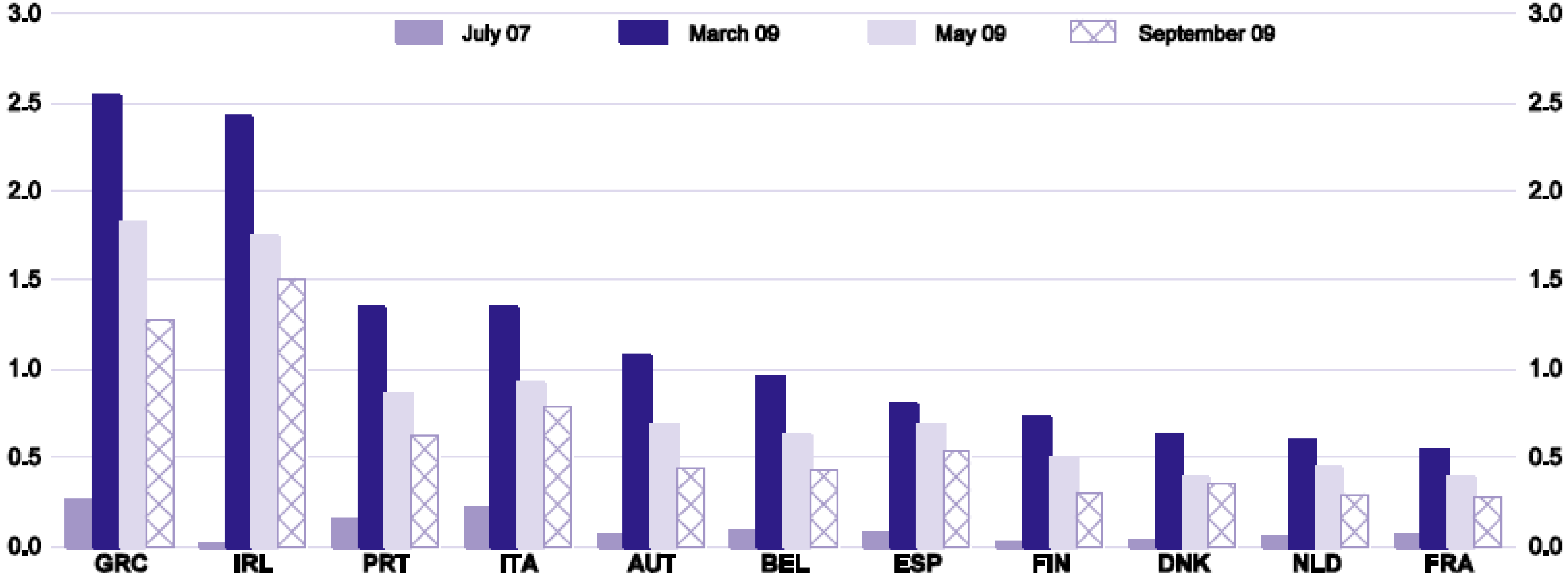


Note: Bars represent average across all OECD countries for which data are available over the period 1994 to 2008. Short-term interest rates are typically rates on 3-month Treasury bills and long-term interest rates those on 10-year government bonds.

Source: OECD Economic Outlook 86 database.

Figure 1.15. Sovereign bond spreads in the euro area remain above pre-crisis levels

Spread with German yield (percentage points)



Source: Datastream.

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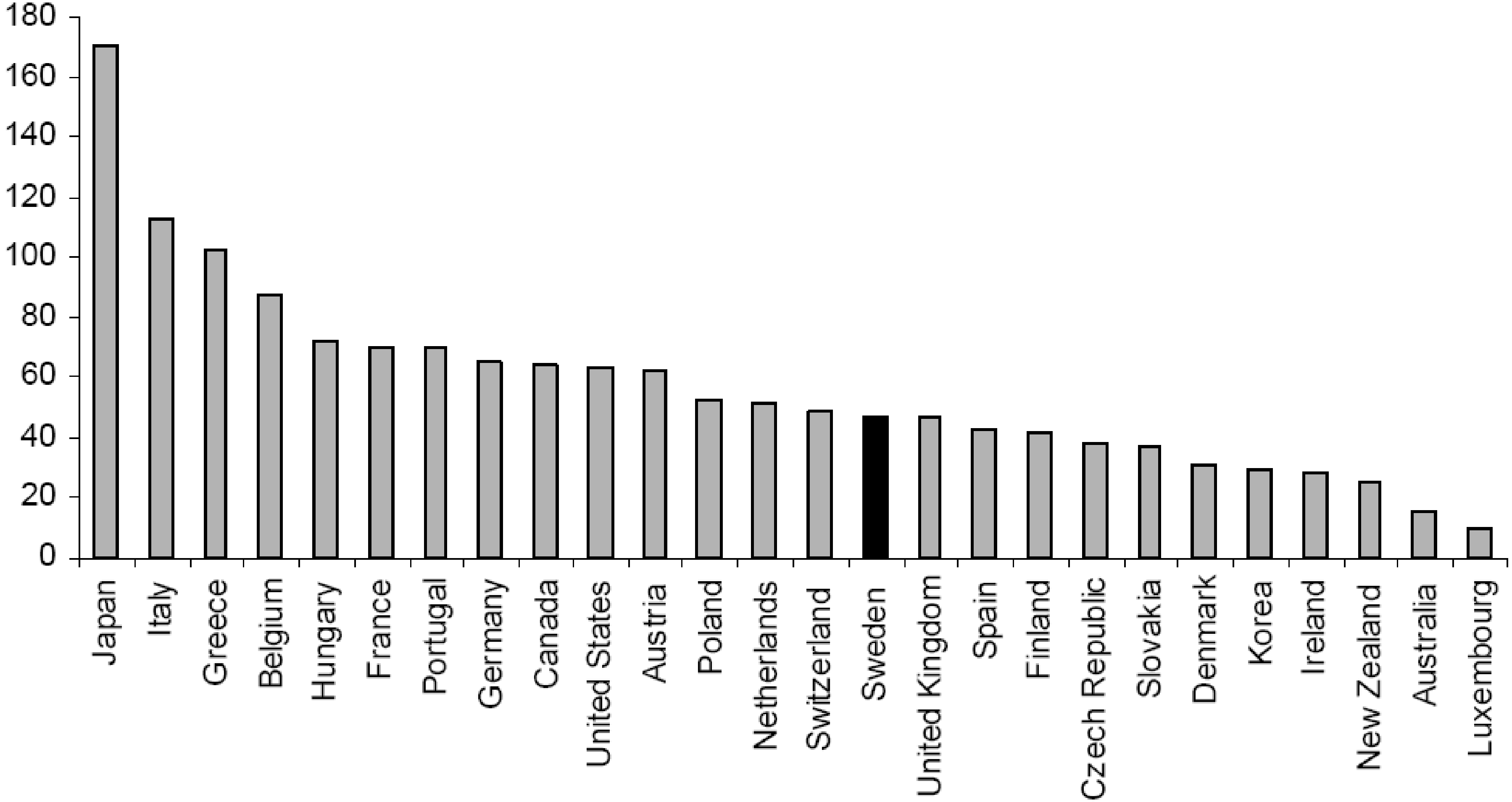
The Swedish situation is different

- Low government deficits and debt
- Favourable sustainability (S2) calculations
- Political consensus on fiscal discipline
- Strong fiscal framework
- Good track record of fiscal consolidation

Figure 1.8 General government gross debt in per cent of GDP



Source: OECD (2008a).

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United Kingdom	12.4
Euro area	**5.8**
EU27	**6.5**

Swedish fiscal policy

- Discretionary stimulus of around 1 per cent of GDP already in 2009 Budget Bill before Lehman Brothers
- Then reluctance to stimulate more until autumn 2009
  - reliance on automatic stabilisers
- Additional discretionary stimulus of around 1 per cent of GDP in 2010 Budget Bill
  - but 2/3 of the stimulus is permanent rather than temporary
  - election concerns?

Sweden - Change in cyclically adjusted fiscal balance (net lending)

	2008	2009	2010
2009 Budget Bill	0.7	-0.9	0.3
2009 Spring Fiscal Bill	1.3	-2.1	-0.2
2010 Budget Bill	0.7	-0.9	-1.2

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Good that selective support has been avoided

- No selective support to the automotive industry
  - such support could have opened the floodgates
  - Swedish car industry has likely to contract
- No selective support to hard-hit municipalities/ regions
  - bail-outs would give moral-hazard problems

What do we do now?

The short-run handling of the on-going crisis: exit strategies

- financial emergency measures
- monetary policy
- fiscal policy

Long-term system changes to avoid future crises

- financial regulation
- monetary policy regime
- fiscal institutions
- research and our way of thinking

Financial-market emergency measures

- Trade-off between risks of new financial-market problems and moral-hazard problems
- Worse problem if emergency measures dismantled too early than if they remain for too long

  - Japan is a warning example

What exit should come first?

Monetary policy

- Too late exit could create a new asset price bubble causing financial crisis in the future

Fiscal policy

- Too late exit would worsen the fiscal sustainability problems

Government debt dynamics

$$d_t - d_{t-1} = p + (i - n)d_{t-1} / (1 + n)$$

d = government debt as a percentage of GDP

p = the primary fiscal deficit as a percentage of GDP

i = interest rate

n = growth rate of nominal GDP

Considerations regarding debt reductions

- The ”easy” way of reducing government debt is to inflate it away

  - but it may be costly to get inflation down again afterwards

- Reduce deficits again

  - tax smoothing theory says that the debt level can be allowed to rise from one level to another in response to the crisis

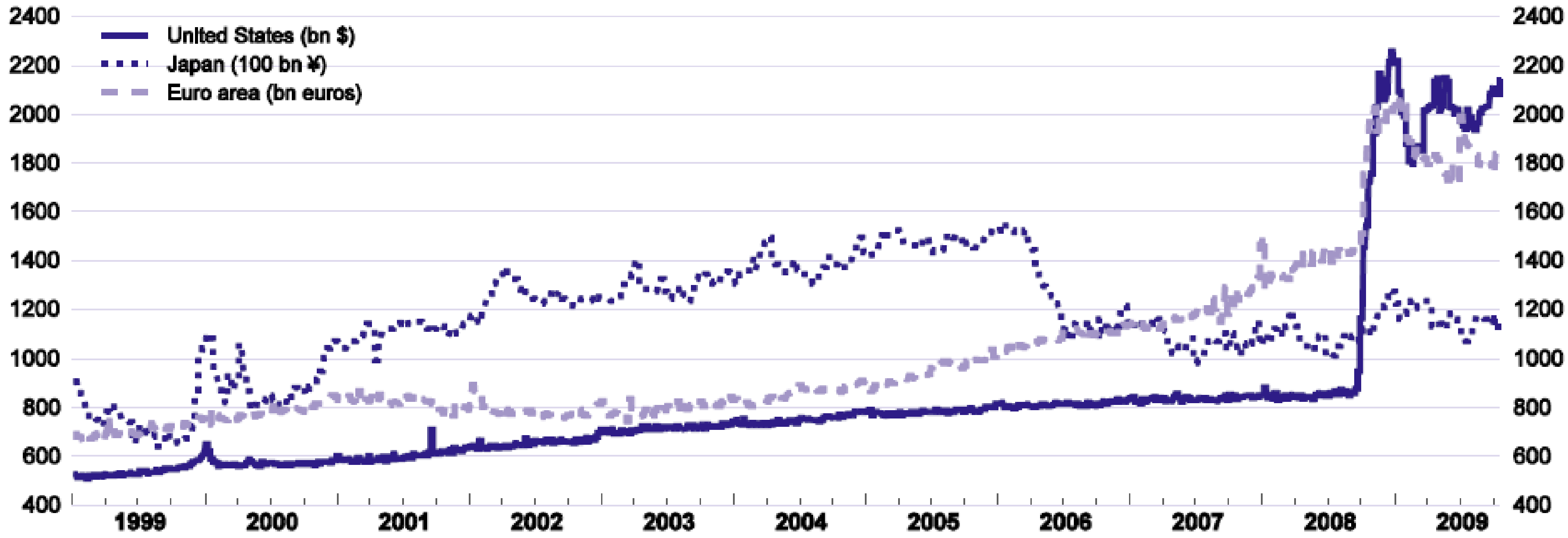
  - but potentially dangerous not to have ”safety margins” in the event of future crises

Commitment to stronger public finances in the future

- Credible commitment would enhance the efficiency of the current fiscal stimulus
- Sweden committed to an **unconditional** path of fiscal consolidation in the 1990s
- But given current uncertainty about the recession **conditional** fiscal consolidation is preferable

  - but it is likely to be less credible
- Future rises of the retirement age may be credible

Figure 1.13. Central bank balance sheets have expanded strongly in the United States and the euro area



Source: Datastream.

With fiscal tightening monetary policy may have to stay expansionary for longer

- The huge expansion of central bank balance sheets is not in itself cause for worry
  - more central bank debt has substituted for the ordinary credit creation in the bank system
  - it should be possible to reduce central bank debt in an orderly fashion when credit markets return to normality
- The worry should be instead that central banks pay too little attention to asset prices

Different policy mix in Sweden?

- Sweden could exit later from fiscal stimulus
- Monetary policy could be tightened earlier to prevent property prices from rising too much
- Our problem is rather to adjust to the actions of others: the recovery of the world economy could take time
  - early exit from expansionary fiscal policy in big countries?
  - high deficits could make expansionary fiscal policy abroad ineffective

System reforms to prevent future crises

- Financial regulation
- The monetary policy regime
- Fiscal policy institutions
- Our thinking in general and academic research

Financial regulation reforms

- (Limits to bonuses)
- Higher capital requirments
- More encompassing regulation
- More international co-ordination
- More focus on macroeconomic systemic risks
- Rating institutions
- Limits on repackaging of loans

o Narrow banking?
o Smaller banks?
o Transformation of debt to equity?

The existing monetary policy regime

- Independent central banks with inflation targets
  - low and stable inflation
  - lower cyclical volatility
  - the **Great Moderation**
- But precisely this policy may allow large imbalances to develop
  - unsustainable asset price hikes
  - overexpansion of credit
  - excessive risk taking
- The existing regime ”takes care of the mosquitos but swallows the camels”
  - smaller disturbances are smoothed but disasters occur from time to time

A reformed monetary policy regime

- The current focus on inflation targeting (and cyclical stabilisation) is too simplistic
- One should probably broaden the objectives to preventing excessive credit growth and excessive asset price swings
  - but what does ”excessive” mean?
  - need for more instruments: cyclical variations in capital adequacy ratios
  - more difficult to hold central banks accountable
- But the problmes with broader objectives may be smaller than the problems with the current system

The fiscal policy regime

- Many contries entered the crisis with too weak public finances and had done too little to deal with the demographic challenge
- EU fiscal rules were not respected
- Stronger national rules are needed

Other countries would benefit from adopting Swedish fiscal rules

- Fiscal surplus of one per cent of GDP over the cycle
- Central government expenditure ceiling
- Balanced-budget rule for local governments
- But also the Swedish rules could be improved
  - restrict possibilities of tax expenditures and movement of payment between years
  - define the fiscal surplus target more clearly
  - better co-ordination of fiscal targets and pension rules
- National fiscal policy councils

Our general thinking and academic research

- Why did we not anticipate the crisis?
- There were warnings

  - house prices

  - global macroeconomic imbalances

- **But**:

  - the crisis occured in a different way

  - the extent of excessive risk taking was a surprise

  - so was the transmission of financial problems

There was a systemic failure on the part of economics

- Lack of integration of macro economics and finance
- Macro economists were not aware of what was happening in financial markets
- Financial markets are not adequately built into macroeconomic workhorse models
- Finance did not focus on general equilibrium macro effects
  - optimal portfolios of individual investors
  - proper pricing of various instruments
- Too much focus on rational expectations and rational behaviour
  - we should learn more from economic history and psychology

Conclusions

- Economists can do better
- Policy makers can do better by already applying the knowledge we have
  - systems to avoid crises and to deal with them if/when they arise
- So far good marks to policy makers for dealing with the financial and economic crisis once it started
- But the jury is still out regarding the exit