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Policies to exit the crisis, and for post crisis challenges

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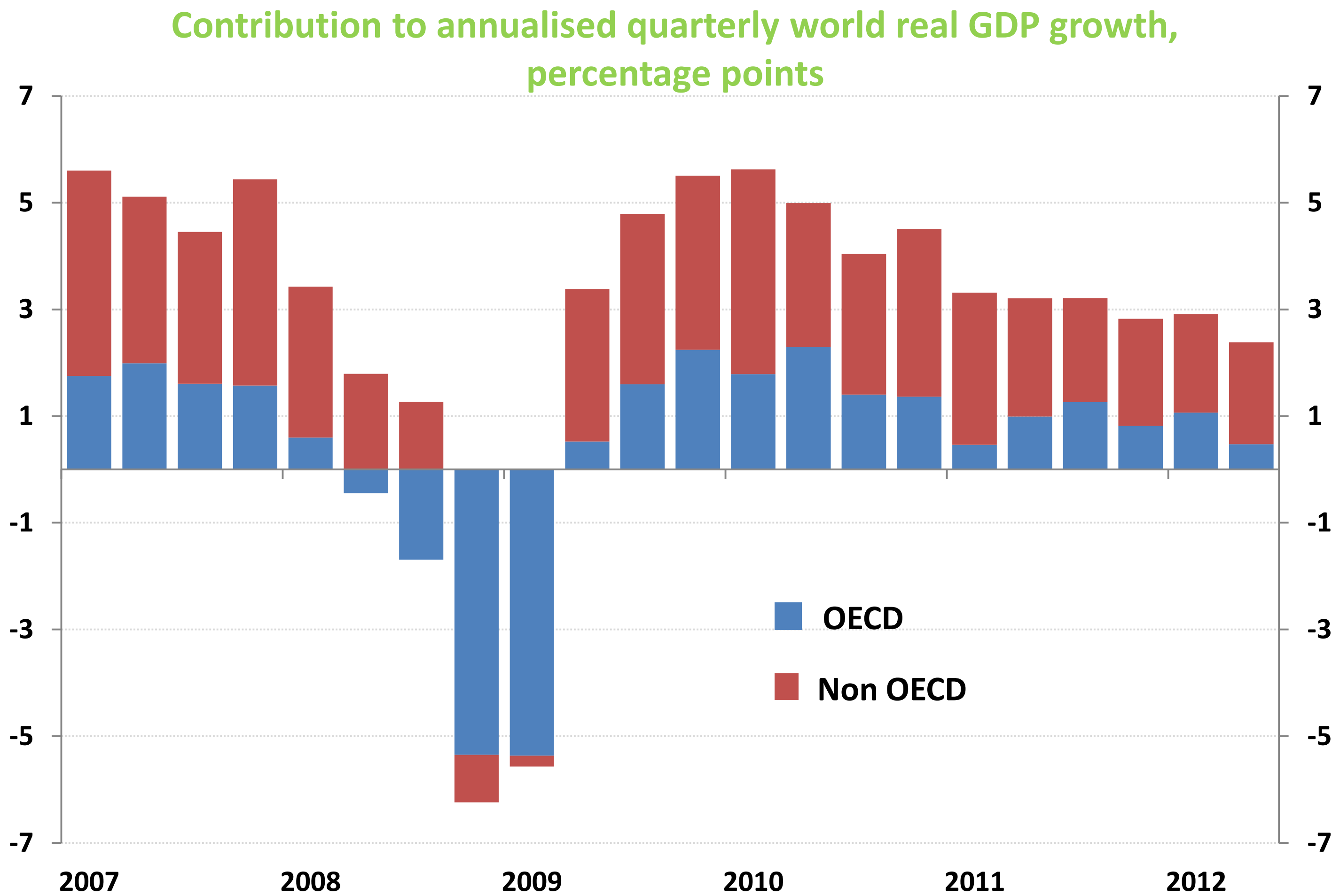
Overview

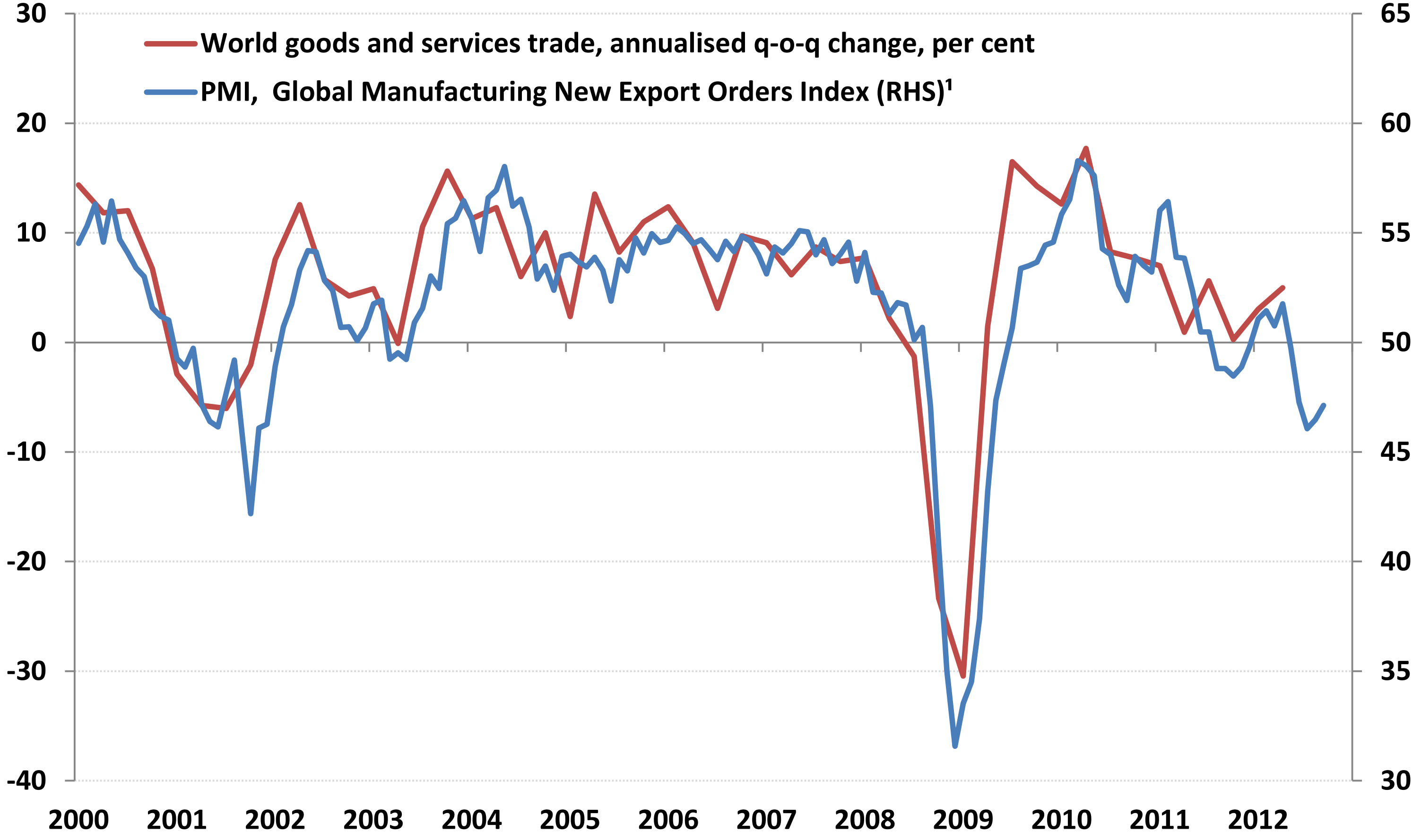
- The crisis is not over yet. Exiting the crisis will succeed if shorter term challenges are linked to the longer term
- Policy can do much to exit from the crisis. Restoring confidence is key in the short term. But links to longer term are also key
- The US. Fiscal policy unsustainable in the long term; monetary policy at the zero bound
- The Euro area. Imbalances and low growth. A three pronged strategy
- The longer term challenges: new sources of growth, debt accumulation, imbalances

World growth has slowed markedly



Note: Calculated using moving nominal GDP weights, based on national GDP at purchasing power parities. Last observation: Q2 2012.
***Source*:** OECD Quarterly National Accounts.

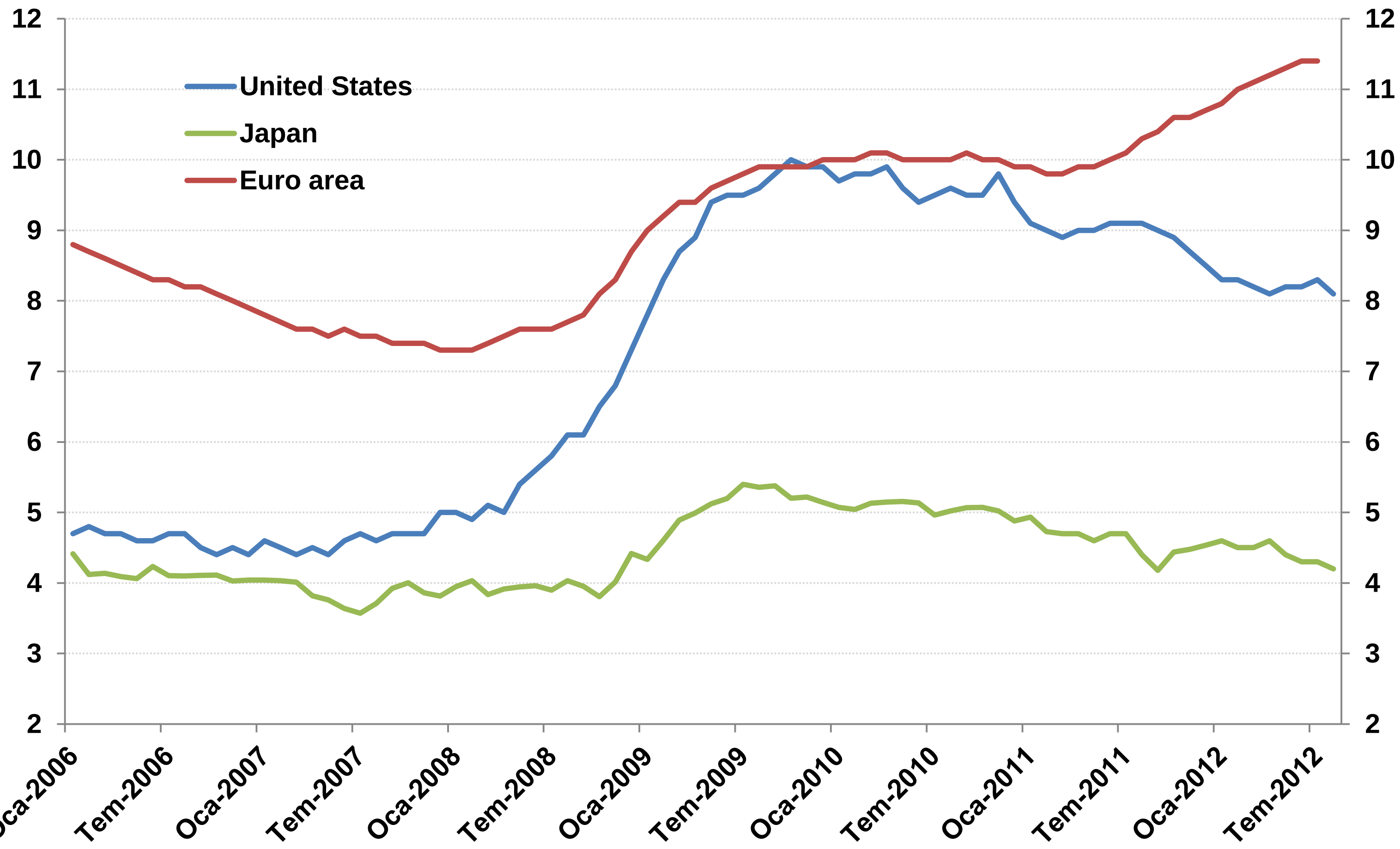
World trade has stopped growing



Note: Values greater than 50 signify an increase in new export orders.
Source: OECD National Accounts database; and Markit Economics Limited.

Unemployment is high and in Europe is on the rise

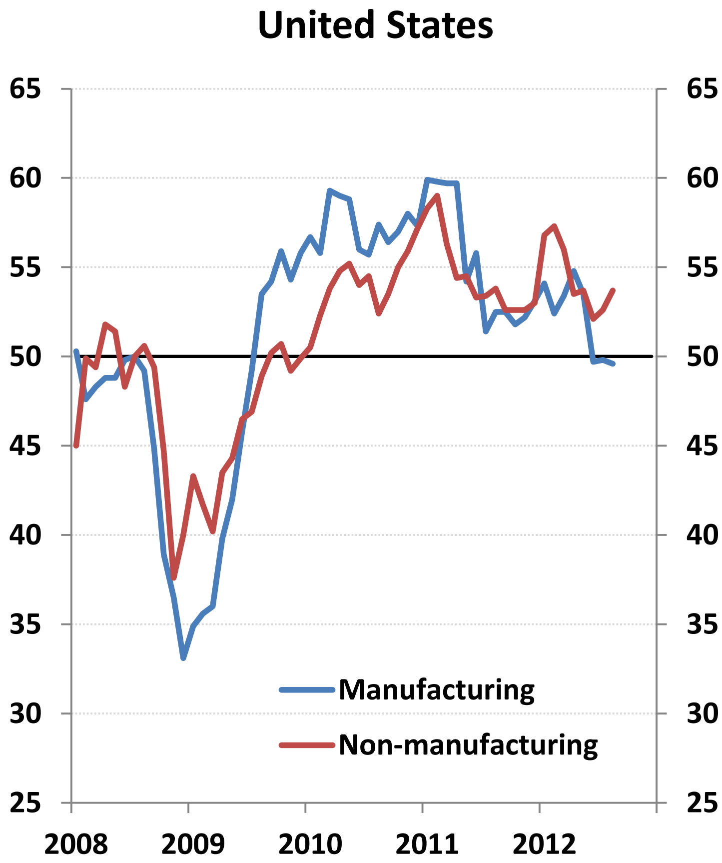
Unemployment rate, percent of labour force

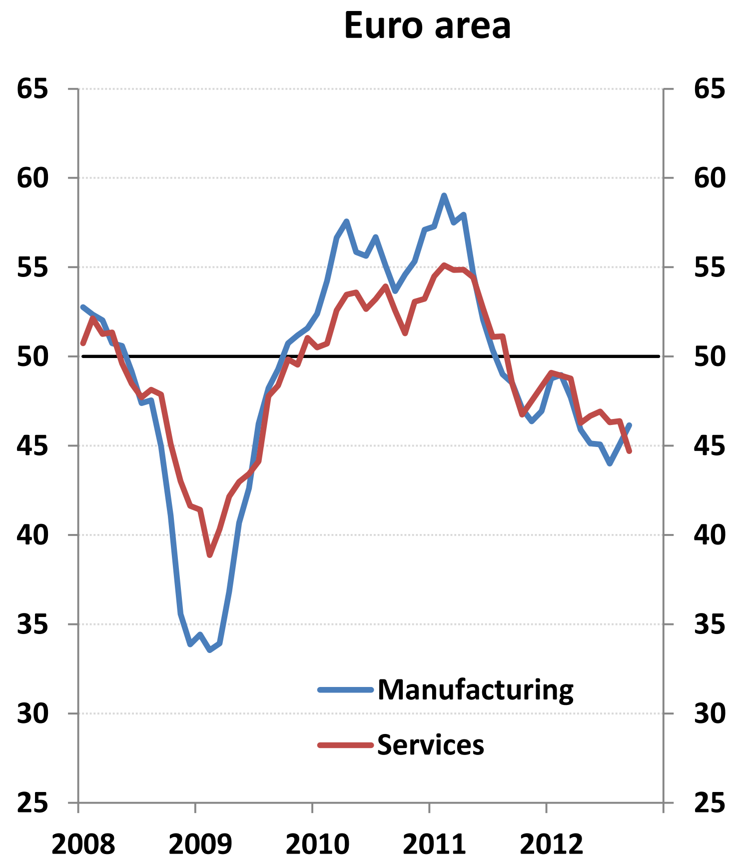


Source: OECD Main Economic Indicators; and Eurostat.

Business confidence hit by euro crisis and US fiscal uncertainty

Purchasing Managers Index (PMI) for manufacturing and services





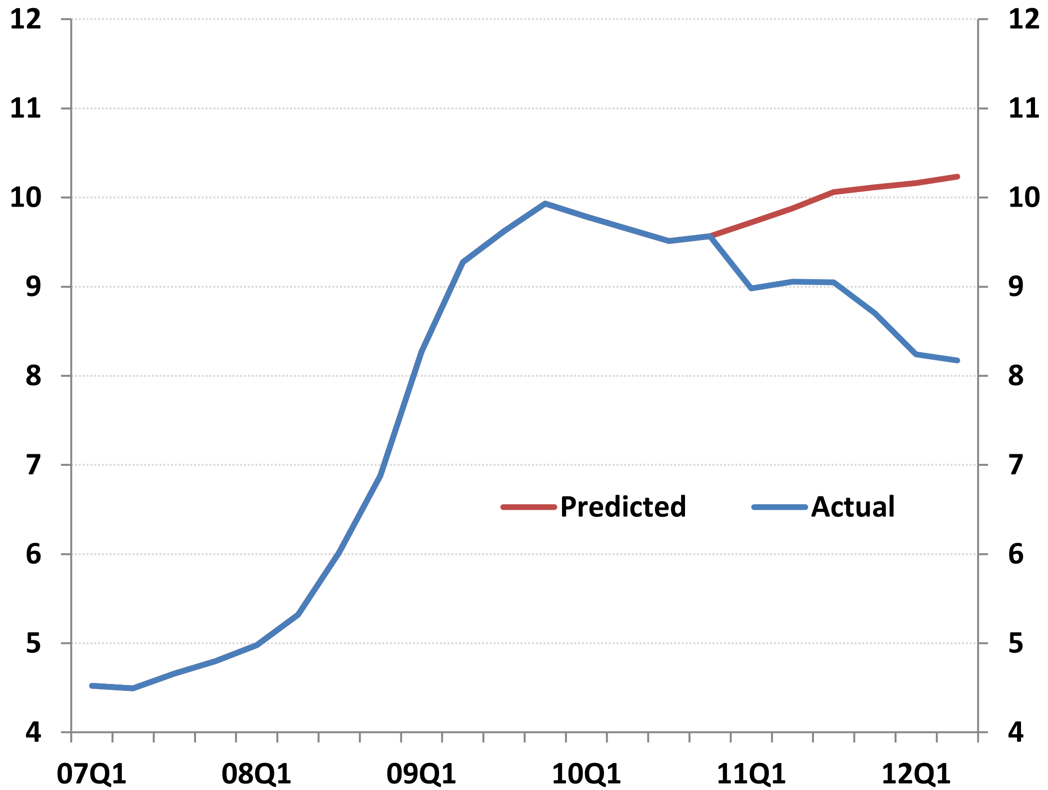
Note: Values greater than 50 signify an improvement in economic activity.
Source: Markit Economics Limited.

The US

- The unemployment challenge
- Avoid the fiscal cliff (would lead to recession)
- Stabilize debt dynamics
- Address the challenges of QE

US unemployment could be higher than observed

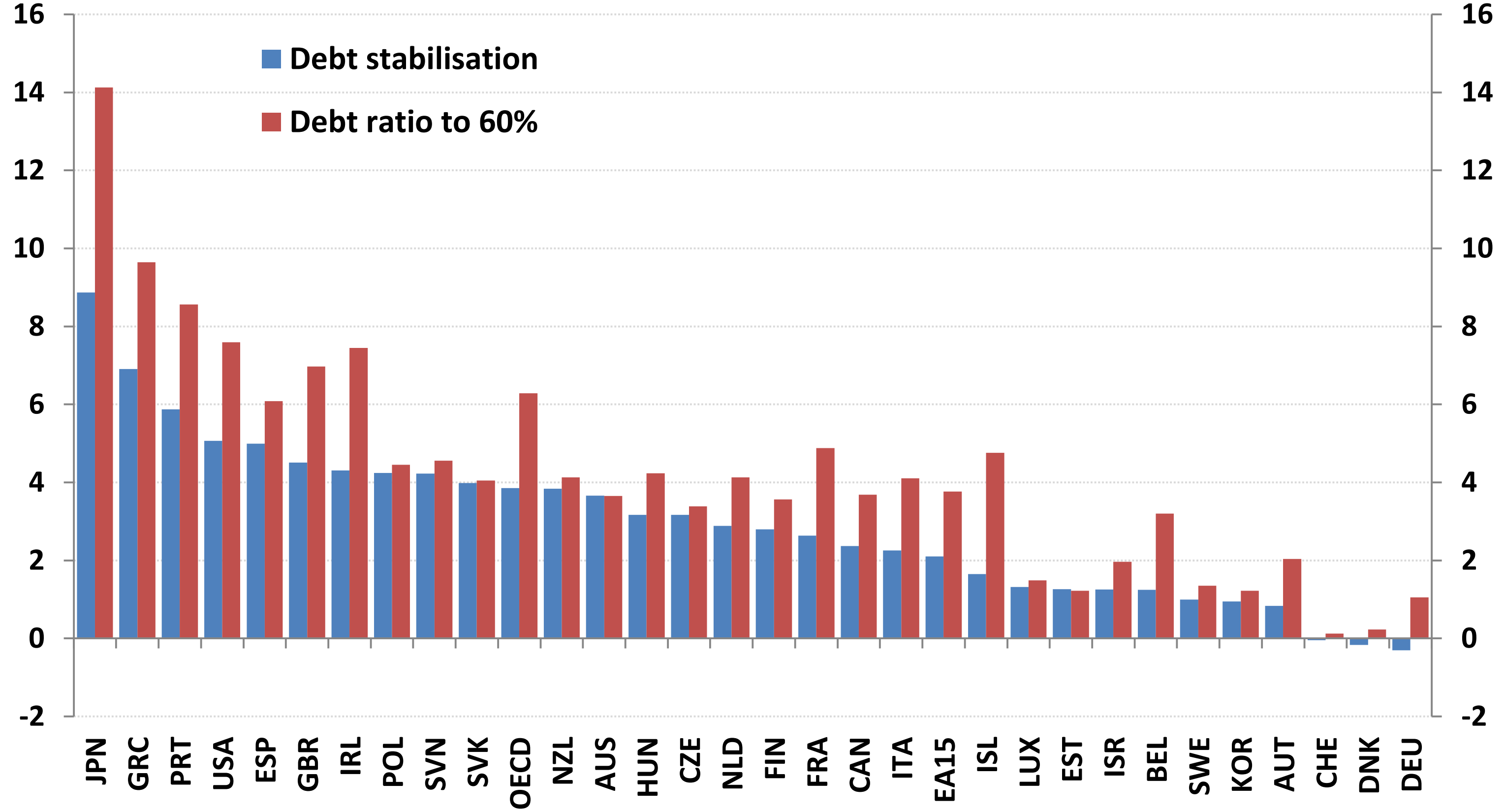
Actual and predicted unemployment rates
United States, percentage points



Note: The predicted unemployment rate is calculated based on the historical relationship between the unemployment rate and output growth (Okun's Law) and actual growth outcomes.
Source: OECD calculations.

Government debt sustainability remains a long-term challenge

Average increase in the underlying primary balance from 2011 to 2030, in percentage points of GDP



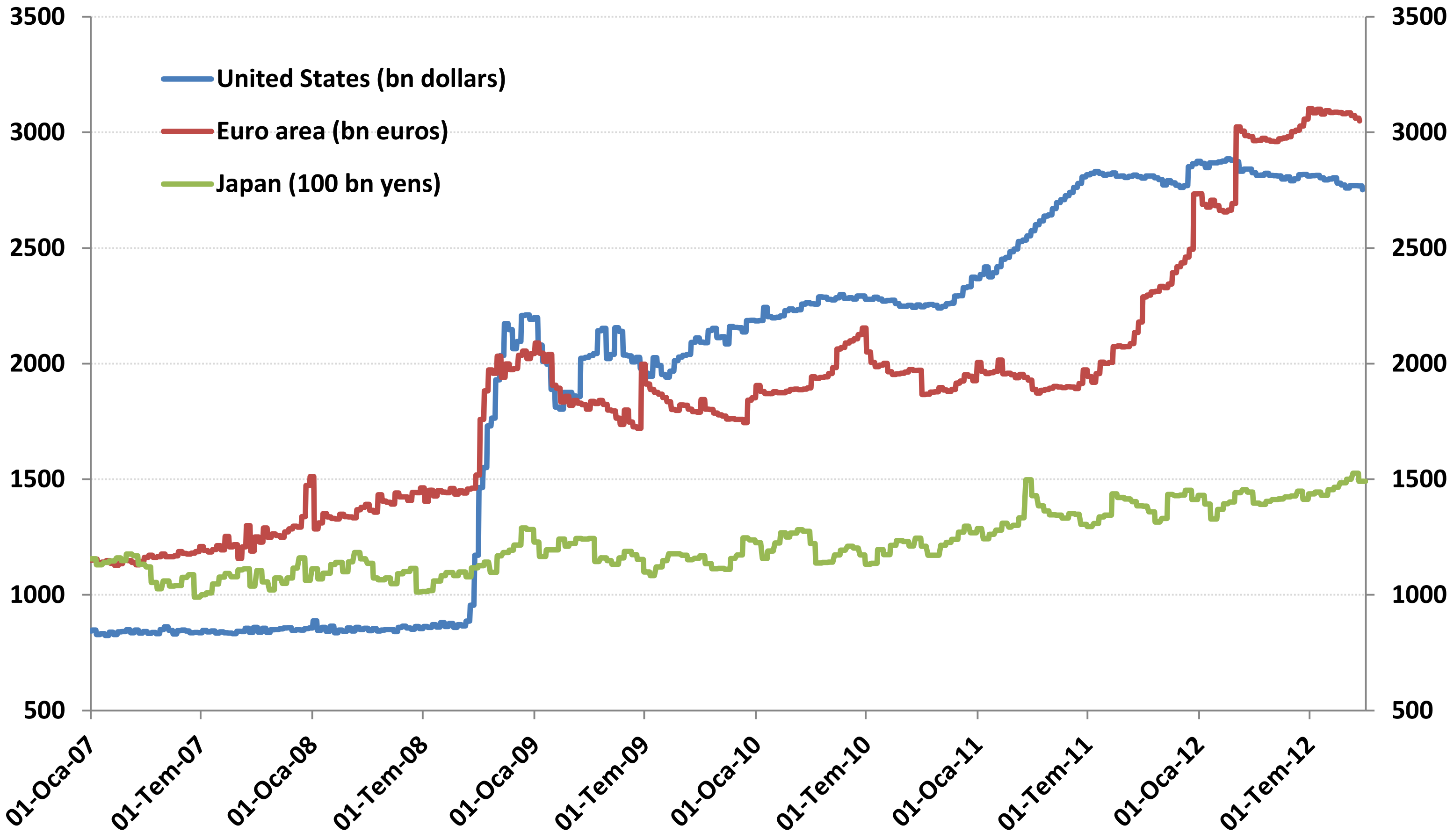
Note: See OECD Economic Outlook 91 for methodology. The bars show the average improvement in the underlying primary balance between 2011 and 2030 necessary to either stabilise government debt ratios or bring them down to 60% of GDP. In Japan's case, the average consolidation shown would be sufficient to stabilise the debt ratio but only after 2030. *Source*: OECD Economic Outlook 91 long-term database.

How far can QE go?

- Erosion of fiscal space and prolonged recession force monetary policy to live at the zero bound for a prolonged period
- QE carries benefits and drawbacks (including because of an increasing public debt burden)

QE (in different forms) has changed size and composition of central banks' balance sheets

Central bank liabilities, local currency



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

QE3

- New round of QE announced by Fed
- Unlimited (conditional upon employment progress)
- Targeted to mortgage backed securities

Impact of QE

- Estimates find that asset purchases corresponding to 1% of nominal GDP reduce long term interest rates by amounts that range from zero to 28 basis points, with an average of 7 basis points

- One study also finds that US quantitative easing depreciated the dollar significantly

- Much less is known about the effects of QE on the overall economy

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Impact of QE

- The link between QE and the public's anticipation of future inflation is not well understood

- There may be a risk that the public may perceive the purchase of government bonds as monetization, which could ultimately result in inflation expectations becoming unanchored. However inflation prospects remain subdued

- Krishnamurthy and Vissing-Jorgensen (2011) evaluate that QE1 and QE2 in the United States raised ten-year inflation expectations by 0.96-1.46 and 0.05-0.16 percentage points respectively. Lam (2011) finds little change in five-year breakeven rates in response to the Bank of Japan's monetary easing in October 2010, which involved five trillion yen (1% of GDP) asset purchases

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Consequences of QE

- QE can potentially entail costs, when purchasing assets closely related to a specific sector's economic activity
- Targeting specific sectors involves a risk of resource misallocation, especially if the target sector is a low-marginal-productivity area such as housing
- Buying private-sector assets may also raise concerns about unfairness, which could ultimately jeopardise public support for monetary policy independence

Exiting QE may be difficult

- Decision to move away from zero interest rates would have to take into account consequences for prices and resource utilisation of falling government bond prices

- Ultra-low borrowing costs create an incentive for banks to roll over bad loans. This implies that near-zero interest rates can exacerbate financial risk in the medium to long-term, in turn reinforcing pressure to keep the "emergency" support of ultra-low interest rates in place indefinitely

Euro area. Three Adjustment processes. Separated but interrelated. Will they be completed in time?

A) **Medium term**: rebalancing and growth

Changes in domestic demand, adjustment in competitiveness

This may not be enough, also given low growth. Structural measures needed

B) **Long term**: institution building banking union, fiscal integration, growth compact

C) **Short term**. Crisis management, dealing with debt traps

The medium term. Strong growth requires sustainable current account imbalances

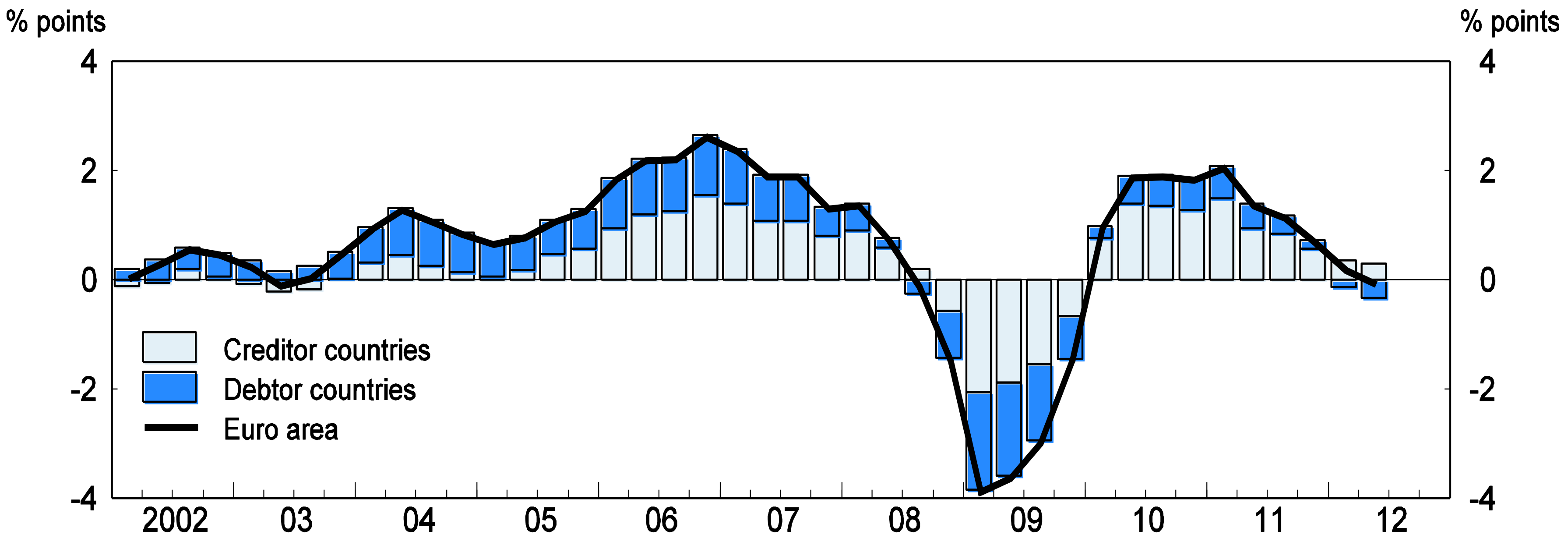
- The euro area crisis will not be over unless strong and sustainable growth is achieved
- Returning to stronger growth requires addressing CA imbalances
- CA imbalances in monetary union are useful (necessary) to boost growth through reallocation of savings, but they must be sustainable. Investment must repay itself (good imbalances)
- Countries with CA deficits in the euro area grow much less (or not at all) after the crisis. Higher growth rates before the crisis proved unsustainable

Unsustainable imbalances reflect misallocation

- Not just growth differentials but differences in sectoral growth
- In deficit countries investment largely directed towards non tradables (e.g. housing). Such imbalances do not repay themselves (bad imbalances)
- This (mis) allocation has been magnified by <u>credit flows</u>. Banks' fragility has increased

After the crisis growth is led by surplus countries[1]

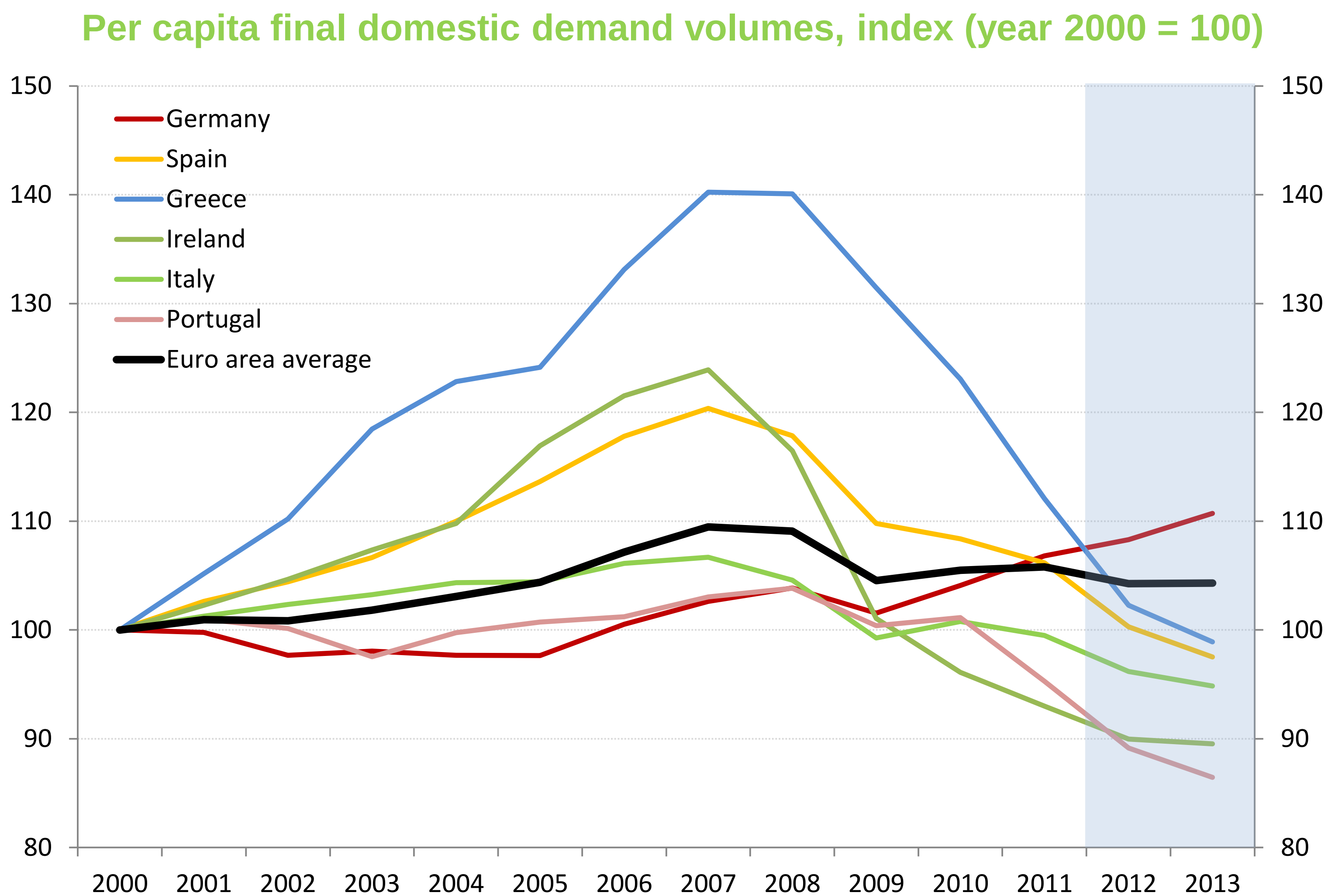
Contributions to year-on-year percentage change of the euro area GDP



1. The deficit and surplus countries are defined by their average current account balance as a share of GDP between 2002-07. 'Deficit countries' are Estonia, Greece, Ireland, Italy, Portugal, Slovak Republic, Slovenia and Spain, and 'surplus countries' include Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands.

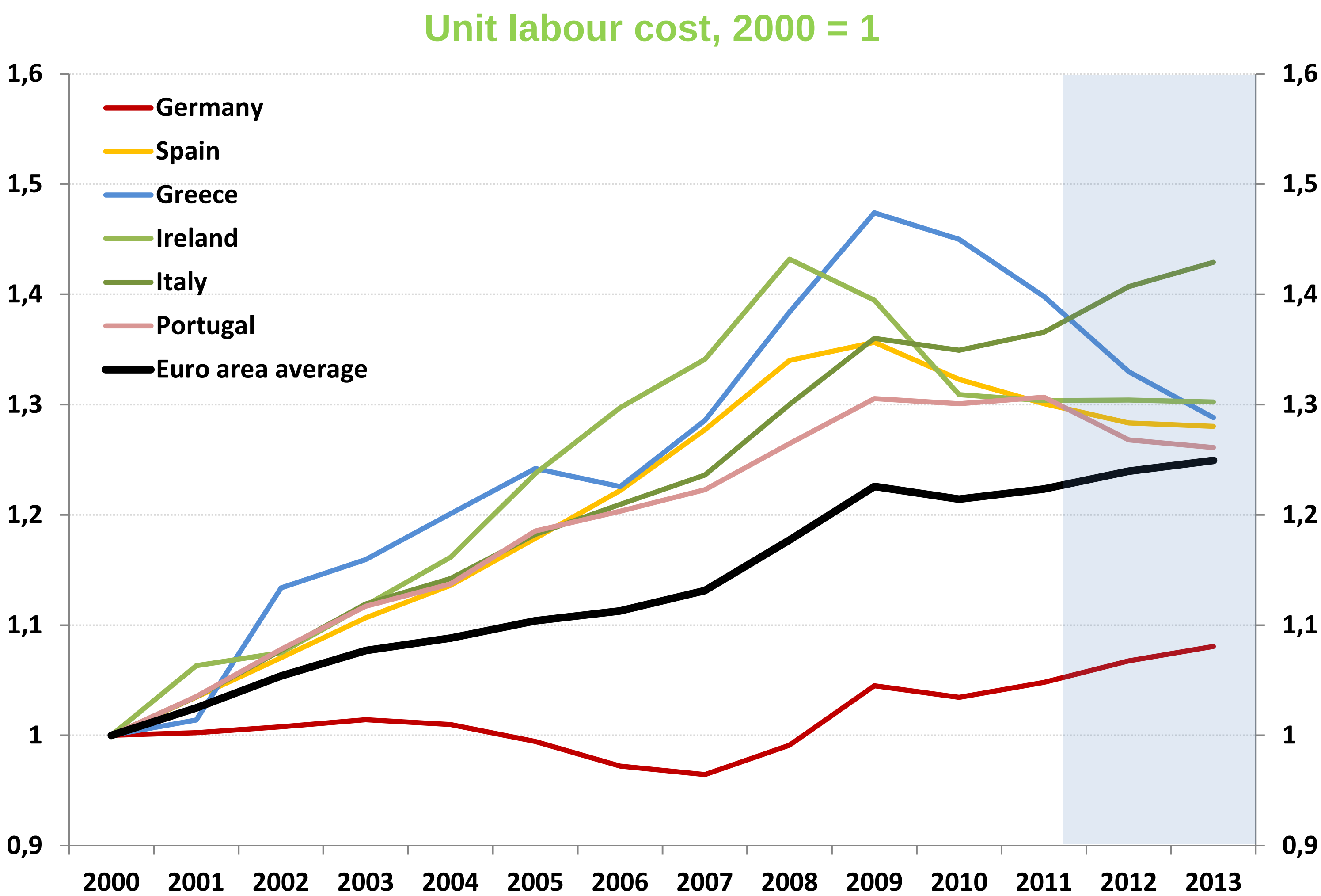
Source: OECD, OECD Economic Outlook database.

Domestic demand is adjusting



Source: OECD Economic Outlook 91 database.

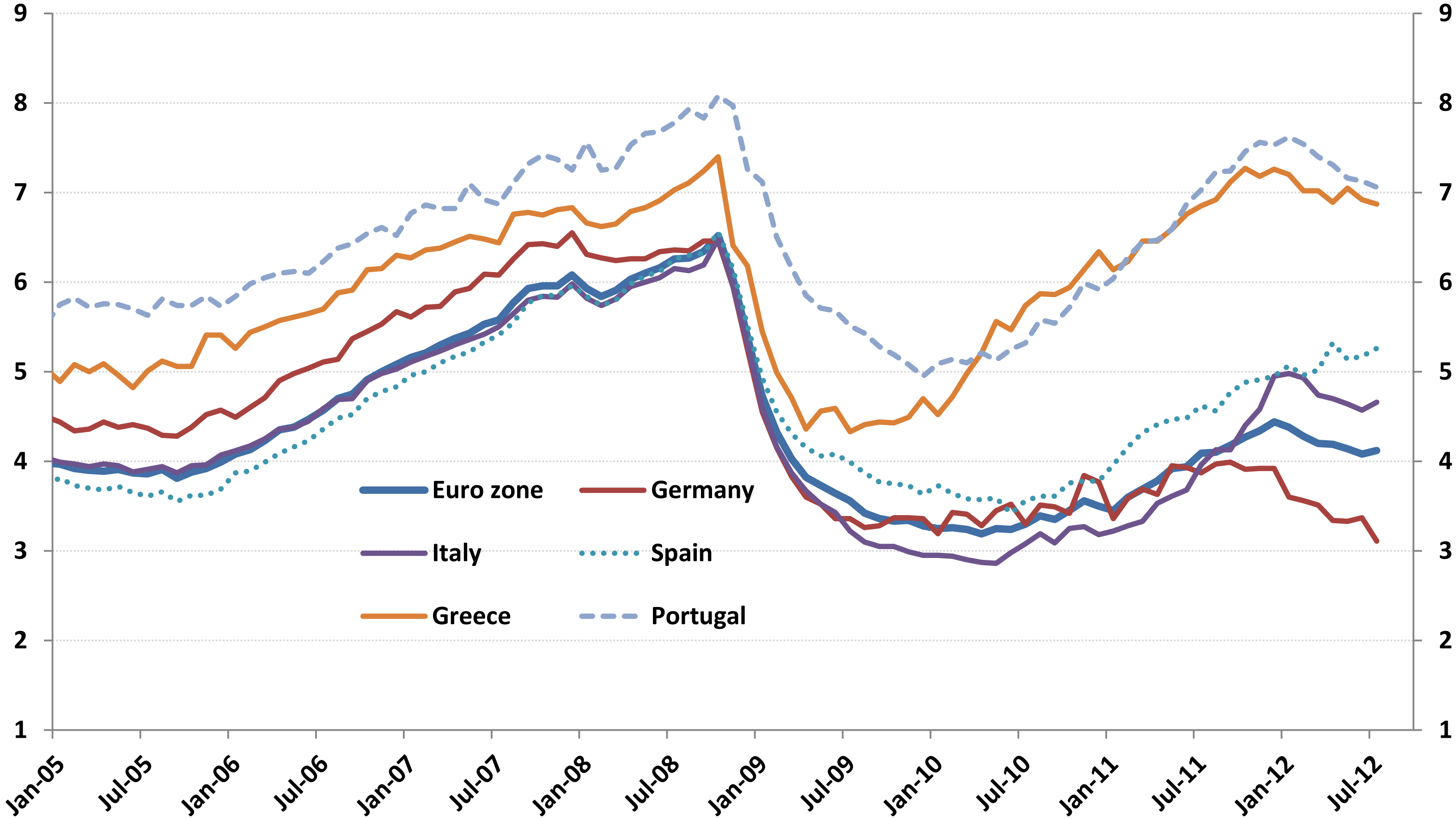
Unit labour costs have begun to adjust



Source: OECD Economic Outlook 91 database.

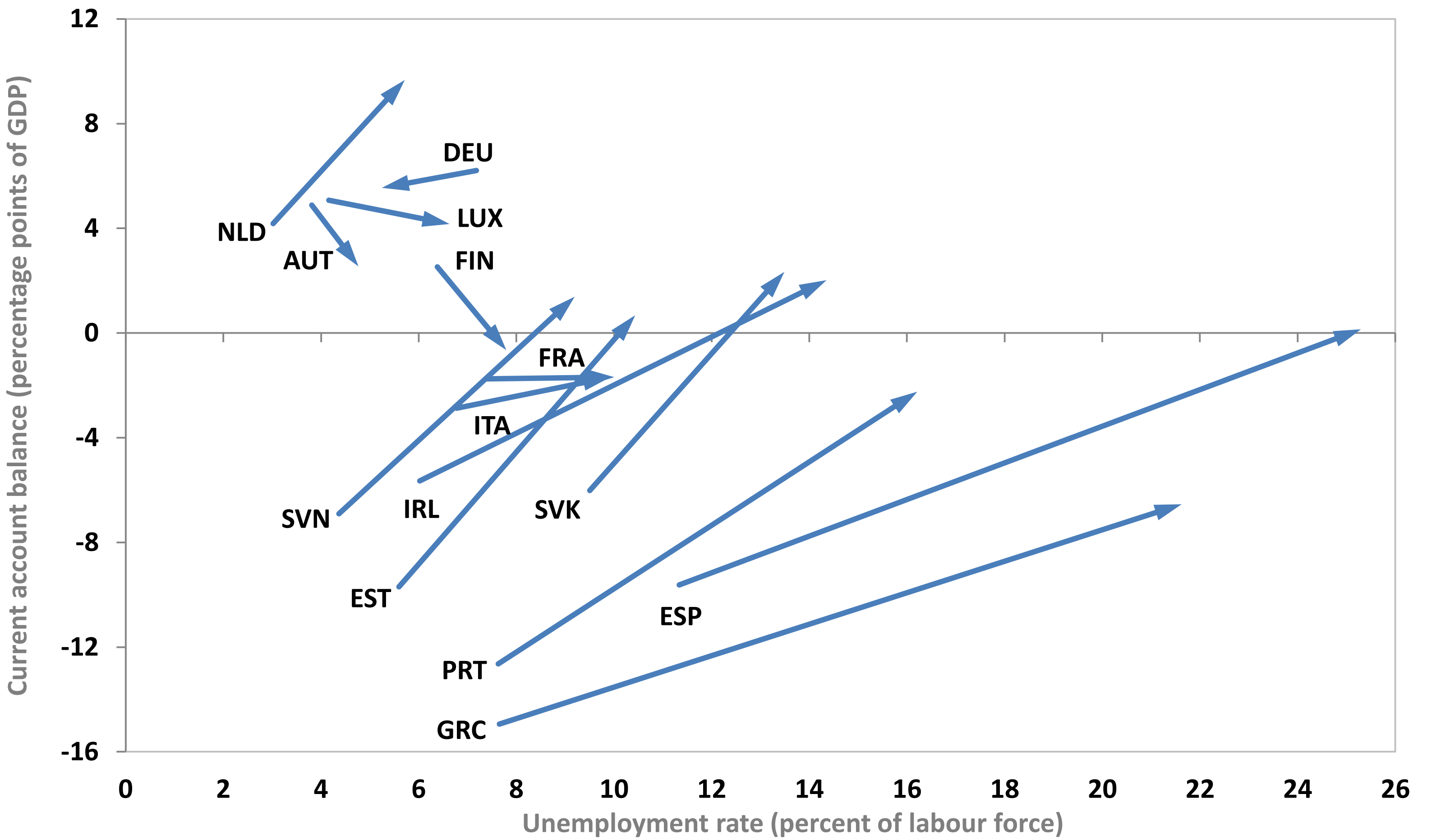
However, sovereign risk premia have spilled over into private funding conditions, aggravating divergence and hindering rebalancing

Interest rates on loans to non-financial corporations



Adjustment is (slowly) taking place: genuine progress? socially sustainable?

Unemployment rate and current account balance, 2008 to 2013



Source: OECD Economic Outlook 91 database.

Adjustment requires structural reforms to boost growth, improve adjustment and allocation mechanisms. It must be more symmetric

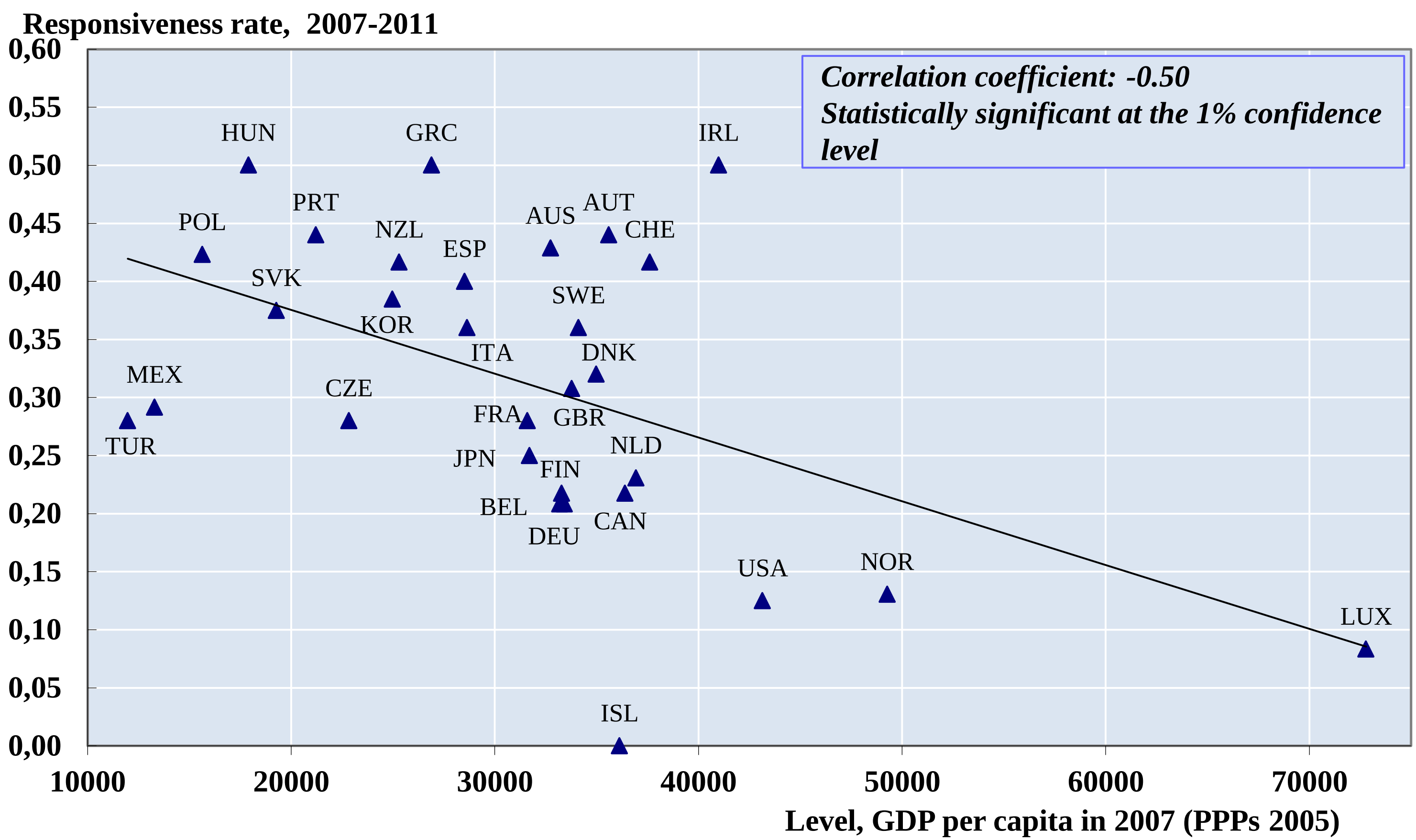
- Adjustment should be more **symmetric** and **growth friendly**

- In **deficit countries** competitiveness in tradable sectors should be improved, wages must adjust but deflation must be avoided

- In **surplus countries** investment opportunities can be enhanced, wages and prices can grow more

Structural reforms can contribute to a growth friendly, more symmetric, adjustment both by closing the savings investment gap and by enhancing competitiveness

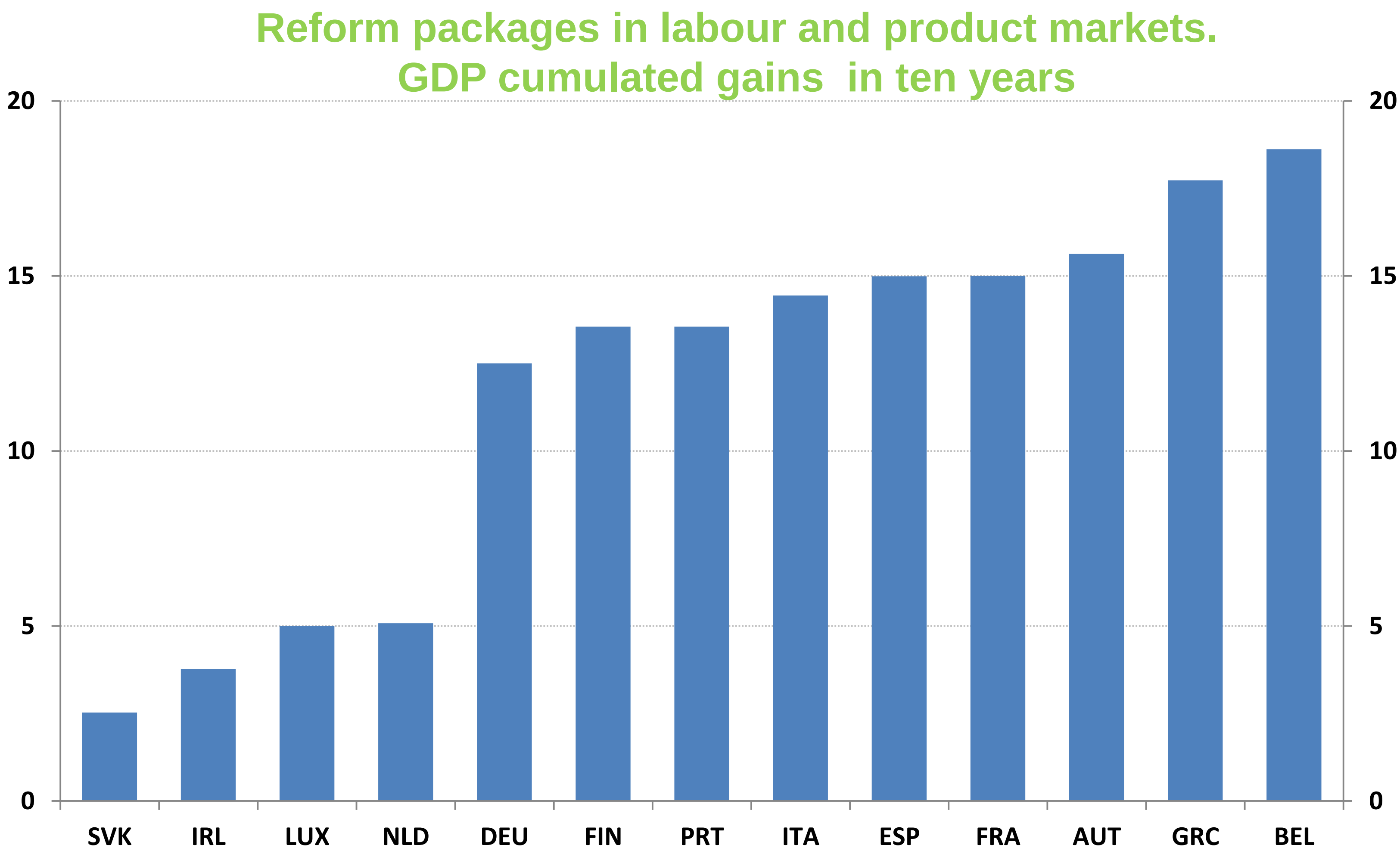
Reforms have accelerated, especially in low income countries



Note: The indicator is the ratio of the total number of years in which some action is taken to address the policy priority to the total number of years in which the policy priority has been identified.

Source: OECD Going for Growth2012.

Reforms boost growth



Note: Estimated cumulative GDP impact from reforms specified in Bouis and Duval (2011).
Source: R. Bouis and R. Duval (2011), “Raising the Potential Growth After the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond”, OECD Economics Department Working Papers, No. 835, Figure 15.

Long term policies are needed for a viable and credible monetary union. Agenda is complex...will take time

Crisis management

- Has been enhanced
- ECB /EFSF/ESM framework is being strengthened

Fiscal integration

- Fiscal compact: implementation, transparency, communication
- EU budget reform

Growth

- Single Market can deliver (much) more
- Innovation can be boosted (EU patent)
- EIB lending, infrastructure investment
- Redirect structural funds

Banking union

- Supervision, resolution, deposit guarantee

The short term challenge. Structural reforms are slow. Institution building takes time …

- SR can produce benefit (higher growth) also in the short term but full impact takes time
- SR short term impact may be weak if activity is low
- In spite of recent acceleration the institutional agenda is inevitably slow(er) than what market pressure would allow
- Political and economic contagion can frustrate reform efforts if market confidence does not improve.

Countries could precipitate in debt traps (high debt, high risk, low growth)

Three negative feedback loops in the euro area could lead to debt traps

- Solvency fears for **banks and their sovereigns** are feeding on each other due to government guarantees for banks and bank holdings of government bonds.
- The possibility of **exit from the euro area** push up yields, which in turn reinforce break-up fears.
- Worries about **government debt** driving up yields, which further weighs on debt dynamics.

The Euro at a crossroads

Downside scenario

- Growth and rebalancing remain subdued
- Long term road map not credible
- A number of countries in debt trap
- Growth and confidence weaken further

Upside scenario

- Growth and rebalancing pick up
- Concrete progress in long term goals
- Countries move away from debt trap
- Growth and confidence reinforce each other

Making the upside scenario happen

- Market impatience may not provide enough time for the upside scenario to materialize. While fundamentals improve slowly systemic concerns raise risk assessments...
- So we need a confidence bridge to deal with impatience
- But buying time will do just this... buy time, unless adjustment pressure is kept at country level (reforms and consolidation)
- And at the institutional level (strengthening the institutions of monetary union)

Adjustment requires strong collective action. The euro can be saved if free riding is avoided

- The euro can be saved and made stronger (i.e. debt traps are avoided) if **all parties involved** do their homework. If **all instruments** are activated in the appropriate fashion:

- **South countries** make progress with structural measures, comply with programs, improve competitiveness and stabilize debt

- **North countries** also make progress in structural reform to boost growth while addressing imbalances

- **EU level growth policies** are activated in the appropriate time frame. Progress in strengthening banking sector/banking union

- **Firewalls** are adequately resourced

- **ECB** operates along the announced guidelines

Failure to deliver in one element/ by one party (free riding) triggers similar reactions by other parties. The downside scenario materializes. Markets would be right to bet on a break up....

Beyond the crisis. Longer term scenarios

- What growth drivers?
- Emerging will continue to catch up. But only up to a point
- Global imbalances will return
- Debt accumulation may be a threat to growth
- What can policy do?

Long term growth drivers

- MFP and Human capital main drivers of long term growth
- EME will catch up but not completely
- MFP will mostly drive catching up (new sources of growth)
  - Innovation
  - Green Growth
  - Intangible assets

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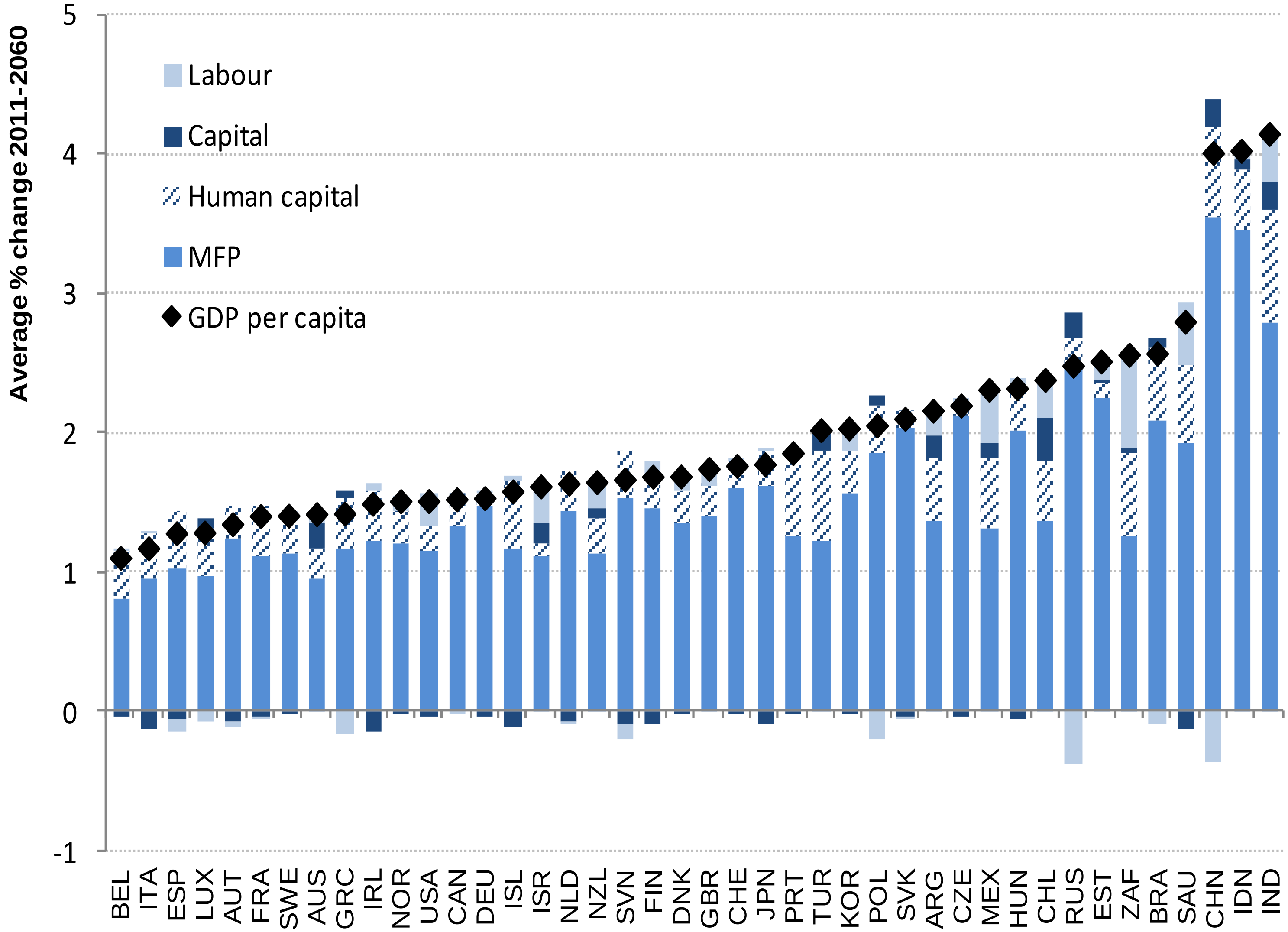
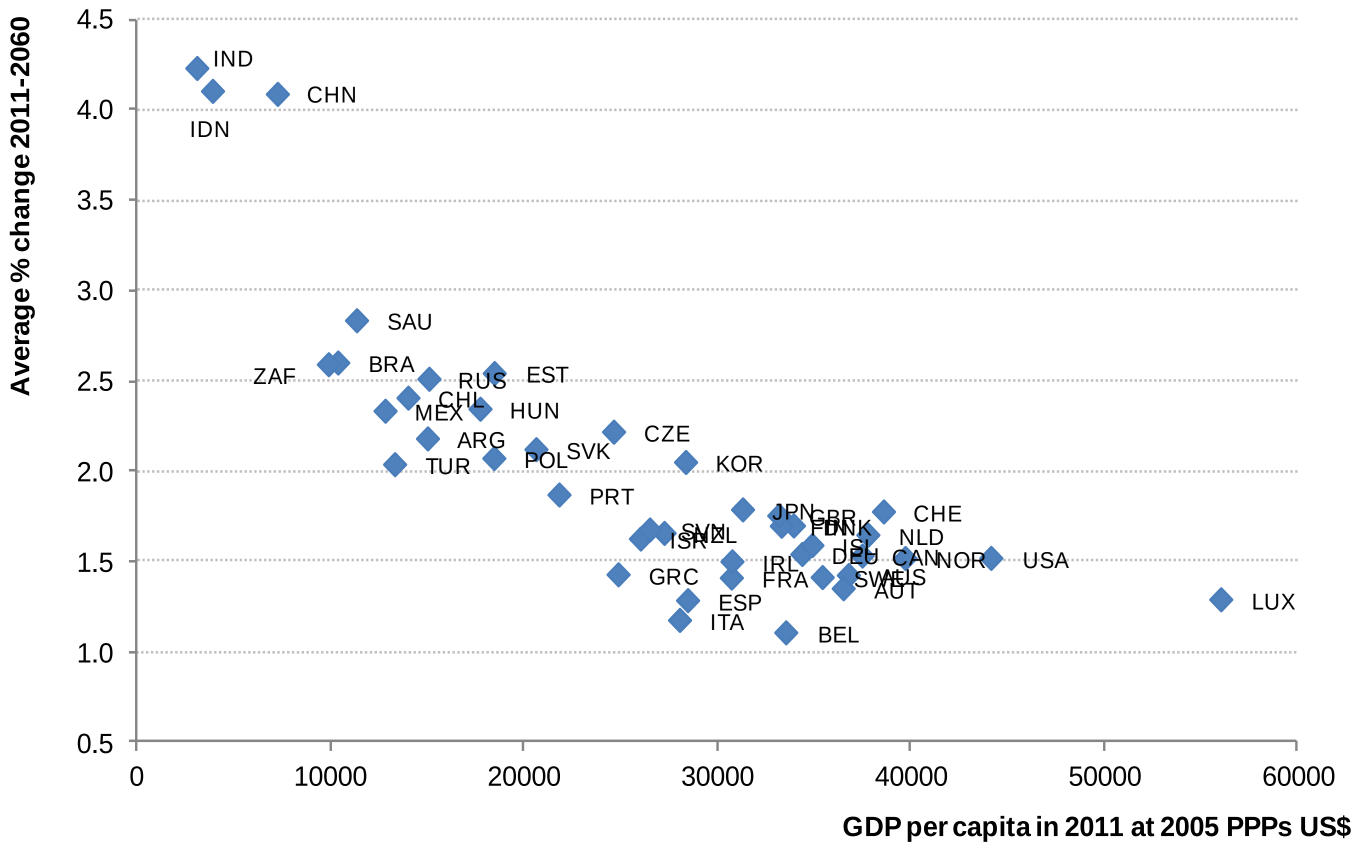
Contribution of drivers of growth to annual average GDP per capita growth 2011-2060



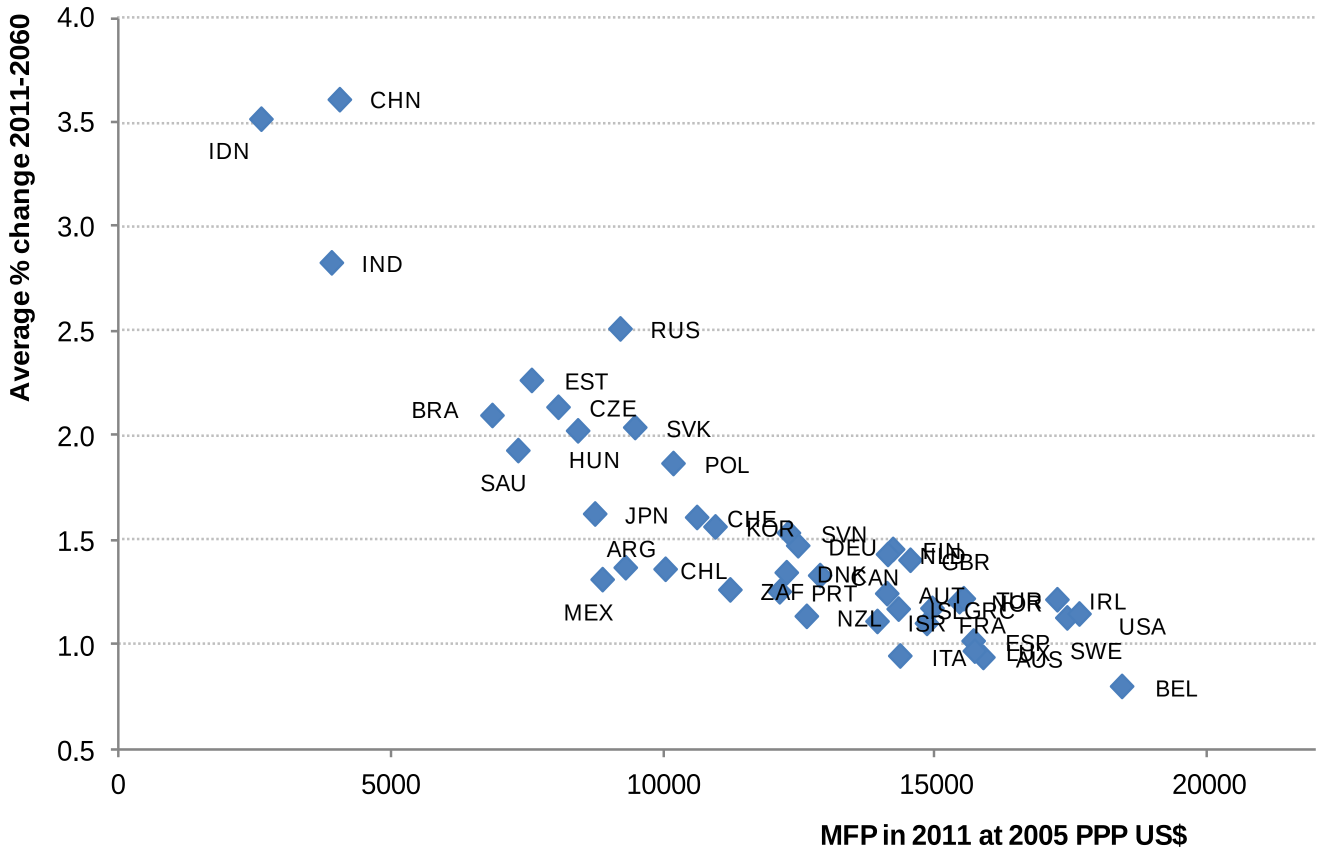
Convergence in GDP per capita across countries is mainly driven by MFP

Initial GDP per capita in 2011 and annual average growth rate 2011-2060



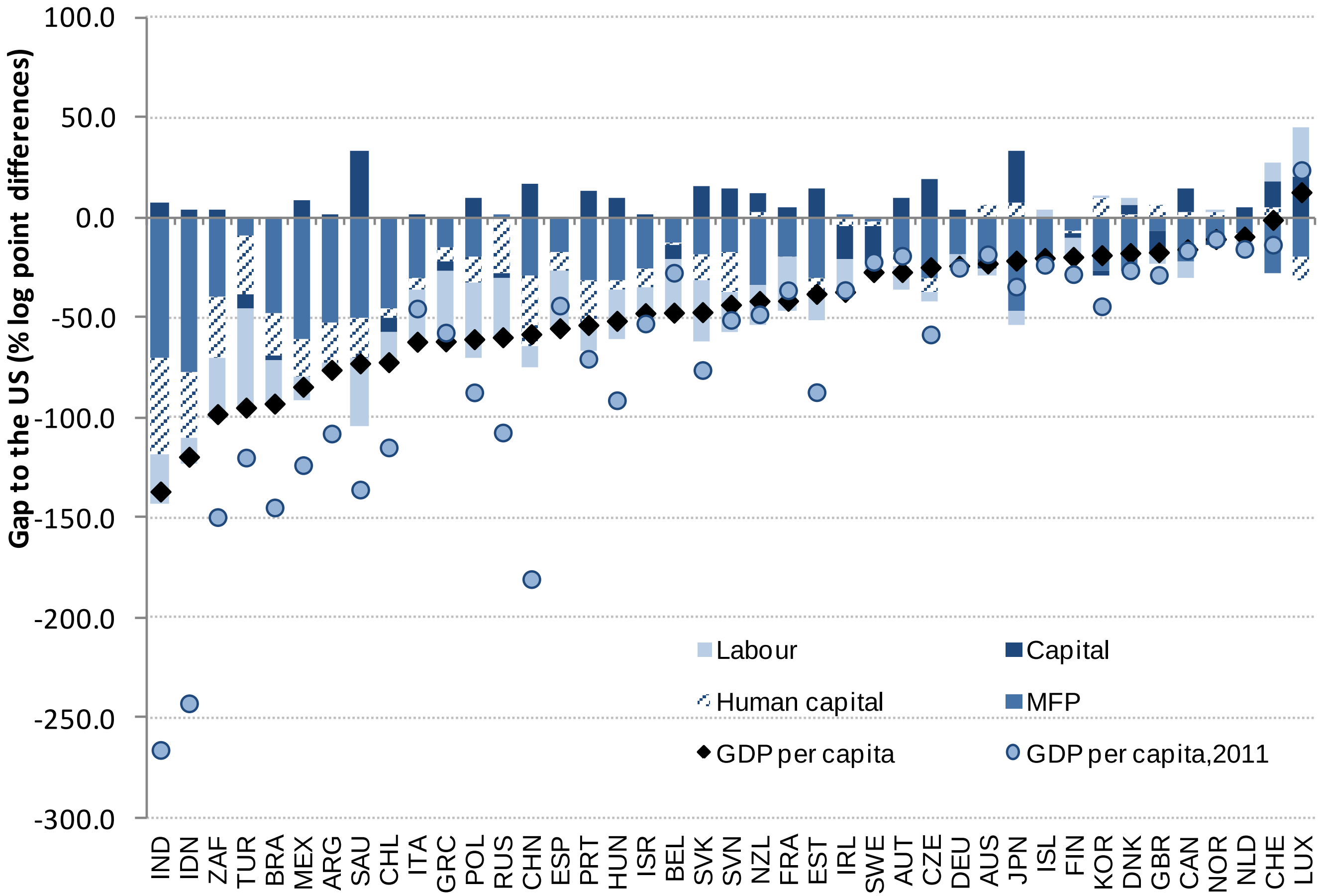
Multi-factor productivity tends to converge across countries over 2011-2060

Initial MFP level and average annual growth in the baseline



Despite substantial gains by emerging countries differences in GDP per capita still remain in 2060

Contribution of production factors to differences in GDP per capita relative to the USA (constant 2005 PPPs)



Global imbalances

- Imbalances are needed to redistribute excess savings (mostly from EME to ADV)
- Imbalances will widen

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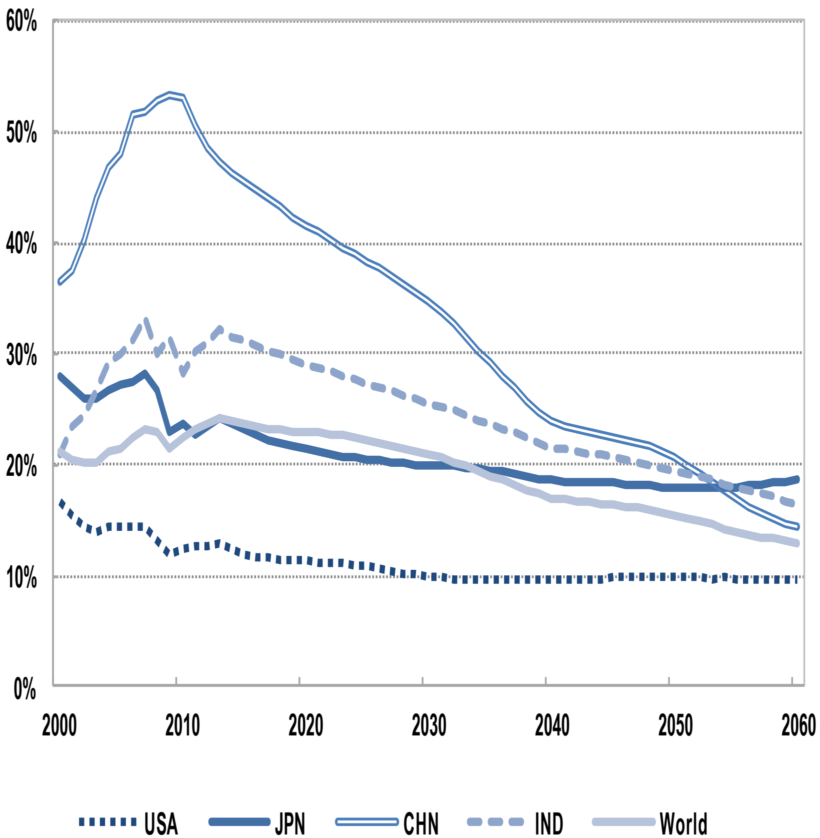
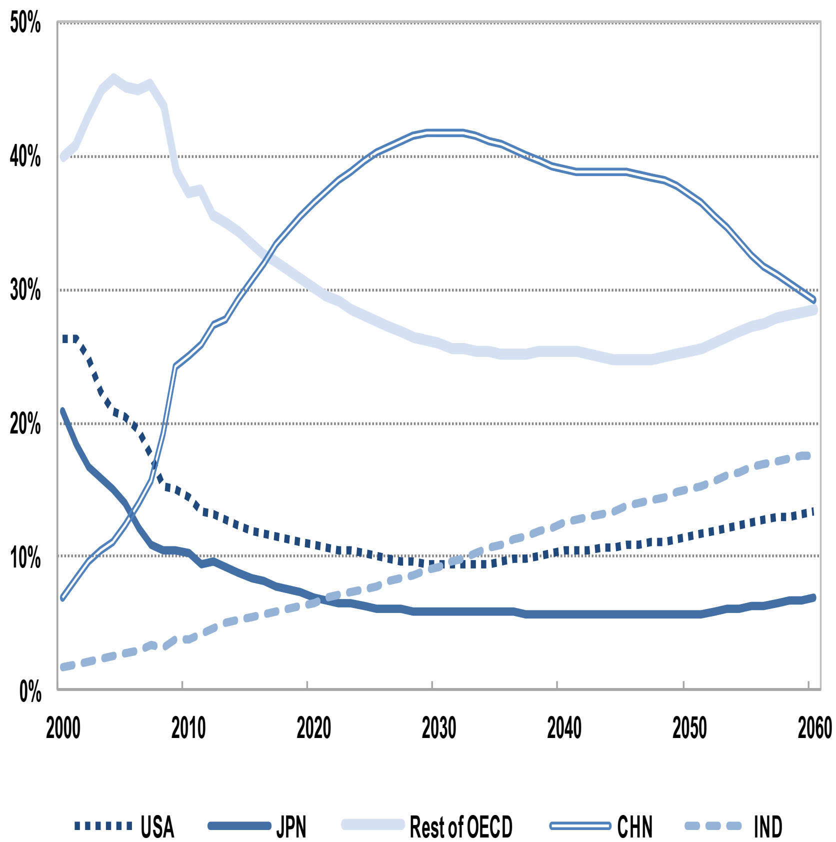
Emerging countries will account for a larger share in global saving

National saving rates (% of GDP)

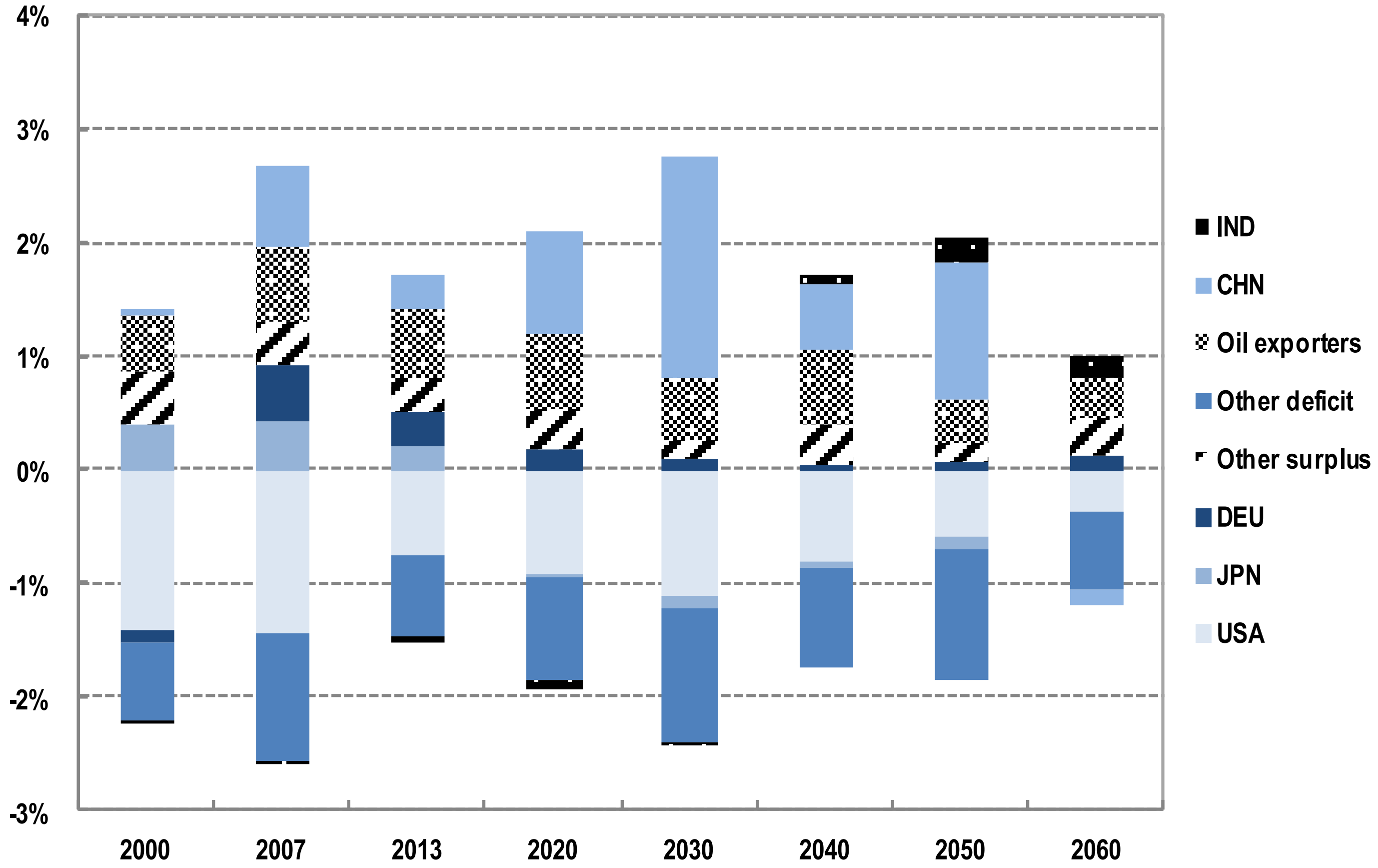


Shares in global savings (%)



Global imbalances are projected to rise over the next two decades

Current account balances as a share of world GDP (%)



Debt and Growth

- Debt/GDP levels are on the rise
- This dynamics:
  - Depresses growth
  - Puts pressure on interest rates
  - Makes debt sustainability more challenging
  - Requires policy action

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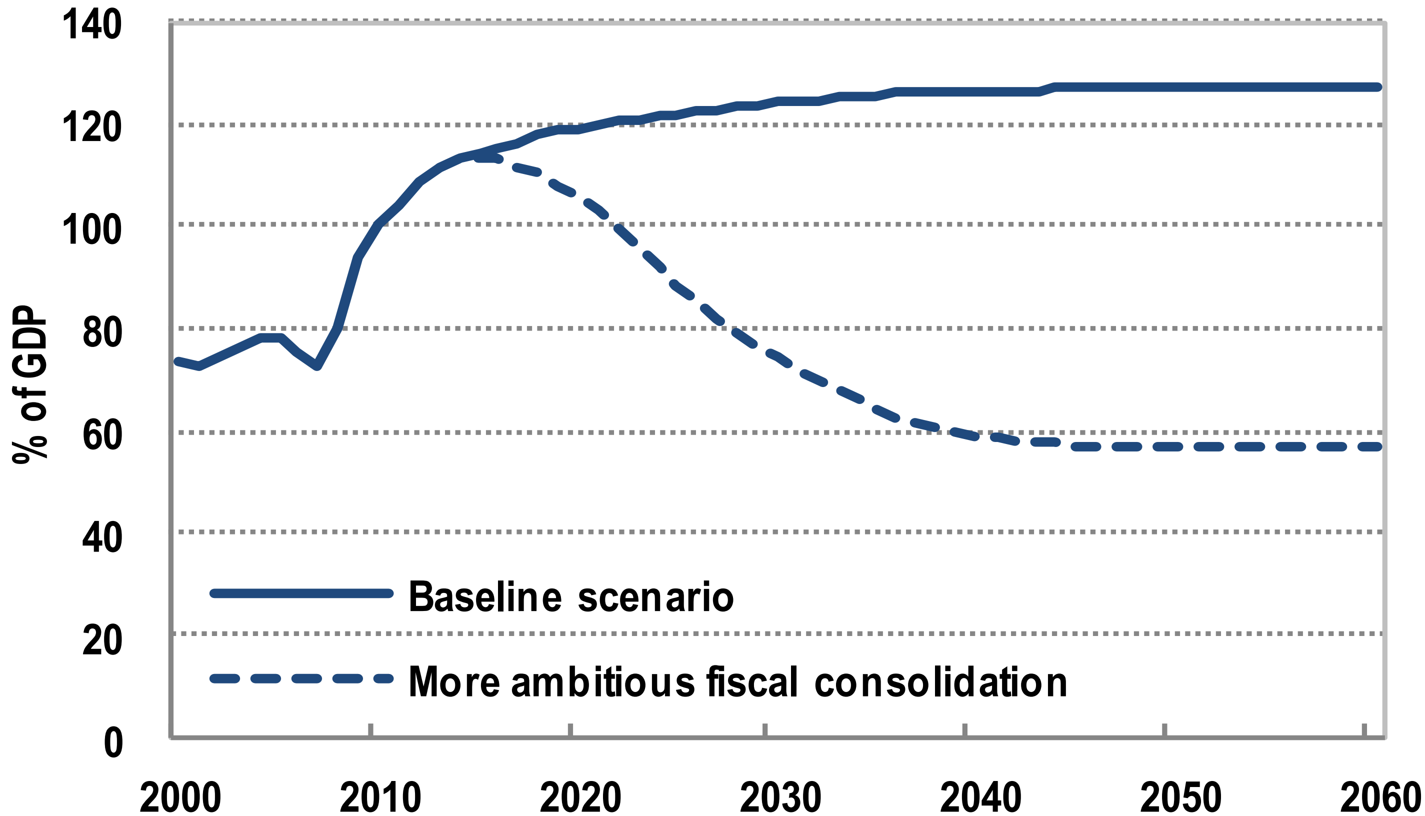
Government indebtedness has increased substantially

- Government indebtedness increases substantially relative to pre-crisis levels. The OECD government debt-to-GDP ratio increases from a pre-crisis level of 73% to stabilise at about 128% of GDP.

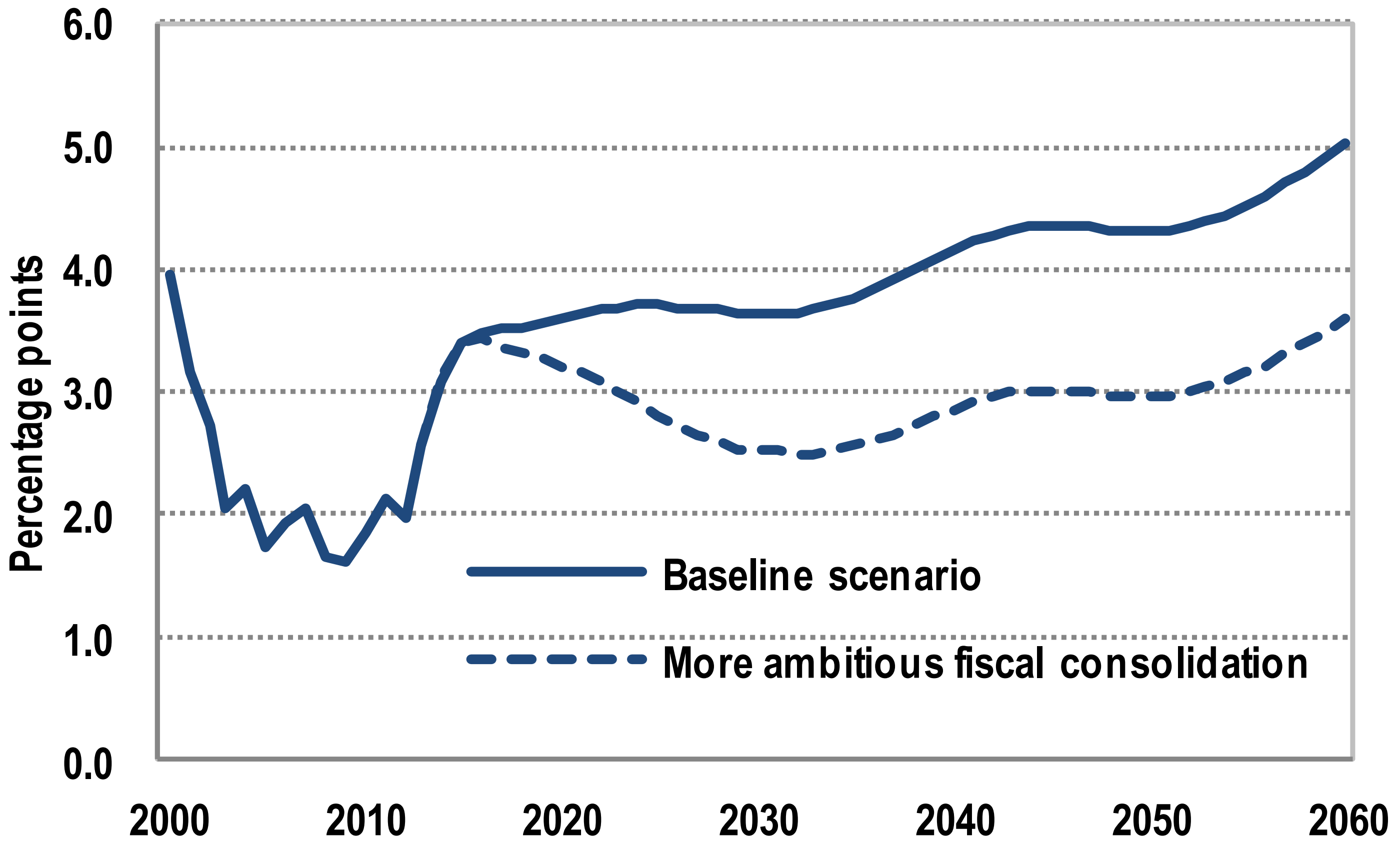
- Government debt-to-GDP ratios are projected to exceed 100% of GDP in ten OECD countries well above levels at which there is some evidence to suggest adverse effects on interest rates and growth.

- Fiscal consolidation can contain debt growth

OECD gross government debt, % of GDP

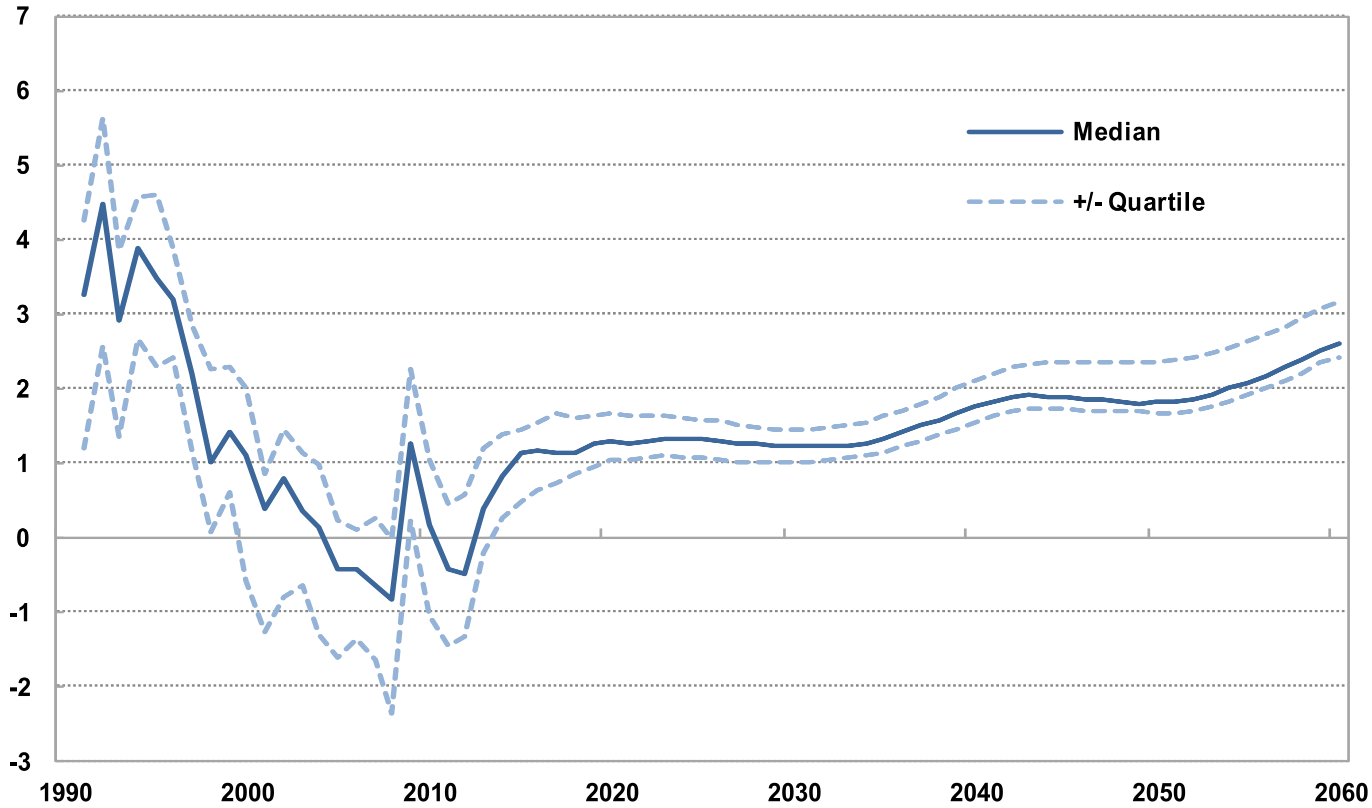


OECD real long-term interest rate under pressure from growing debt

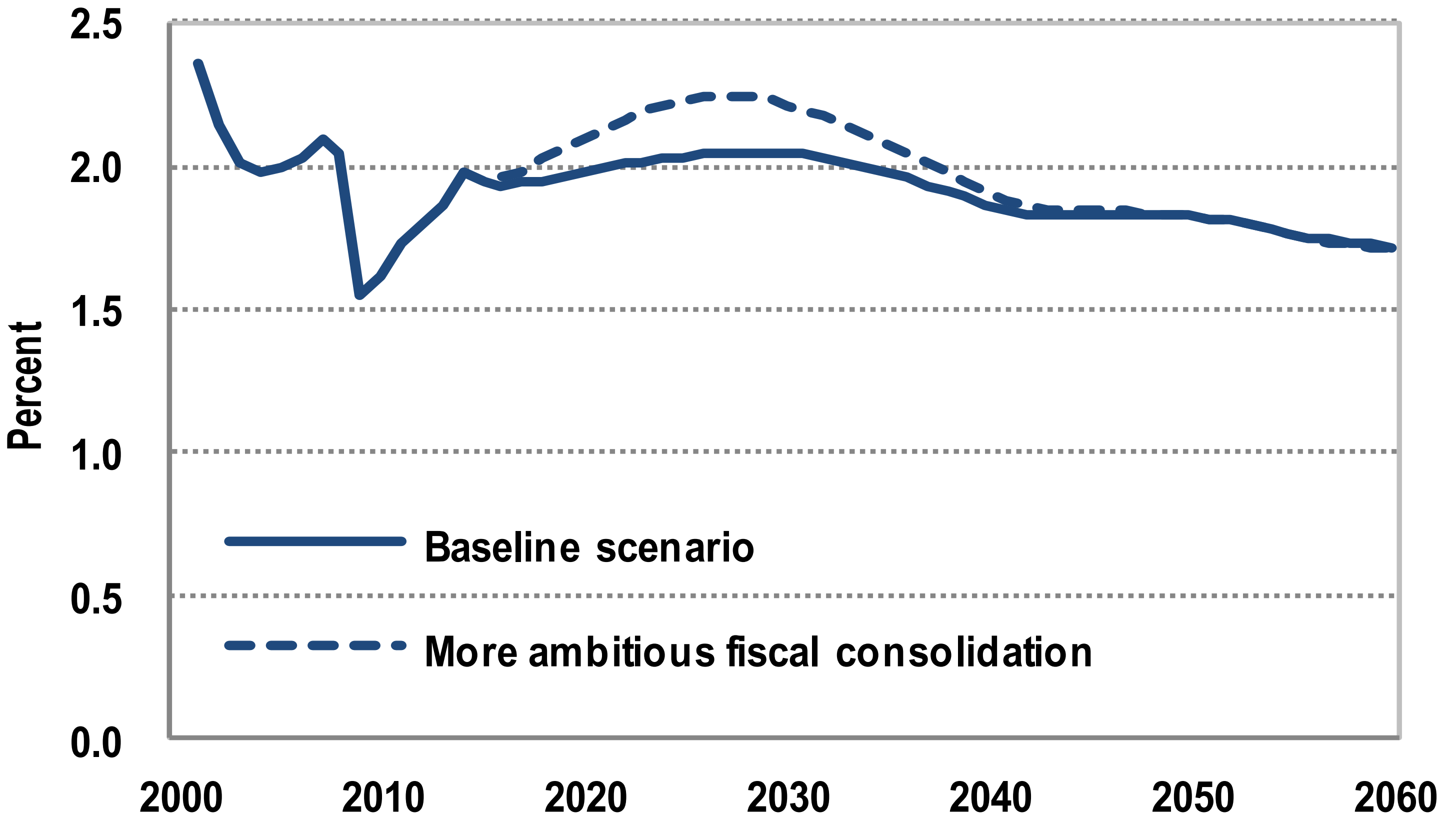


The interest-rate-growth differential is projected to rise among OECD countries

Percentage points



Potential output growth can benefit from debt reduction, OECD average

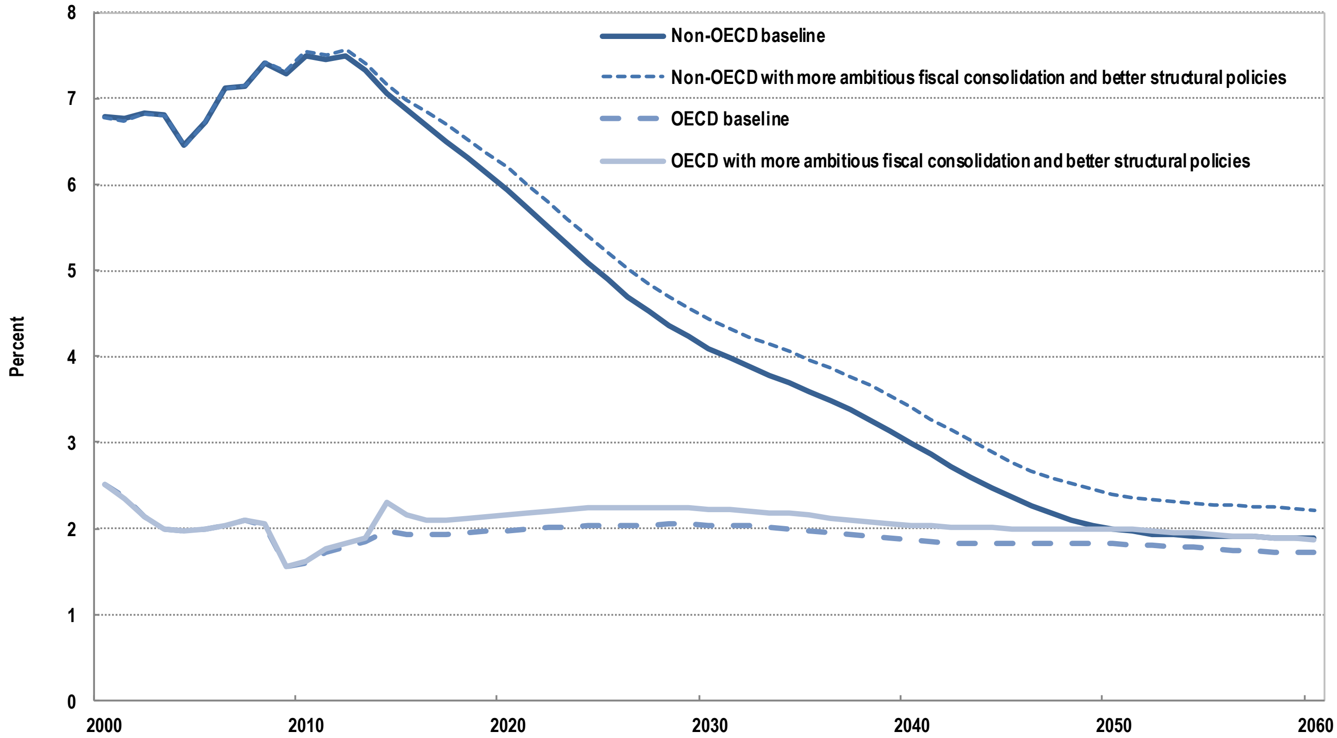


The role of policy to foster long term growth

- Structural policy agenda to move towards the frontier and to move the frontier
- Growth friendly fiscal consolidation to insure debt sustainability
- Addressing global imbalances and enhancing financial stability

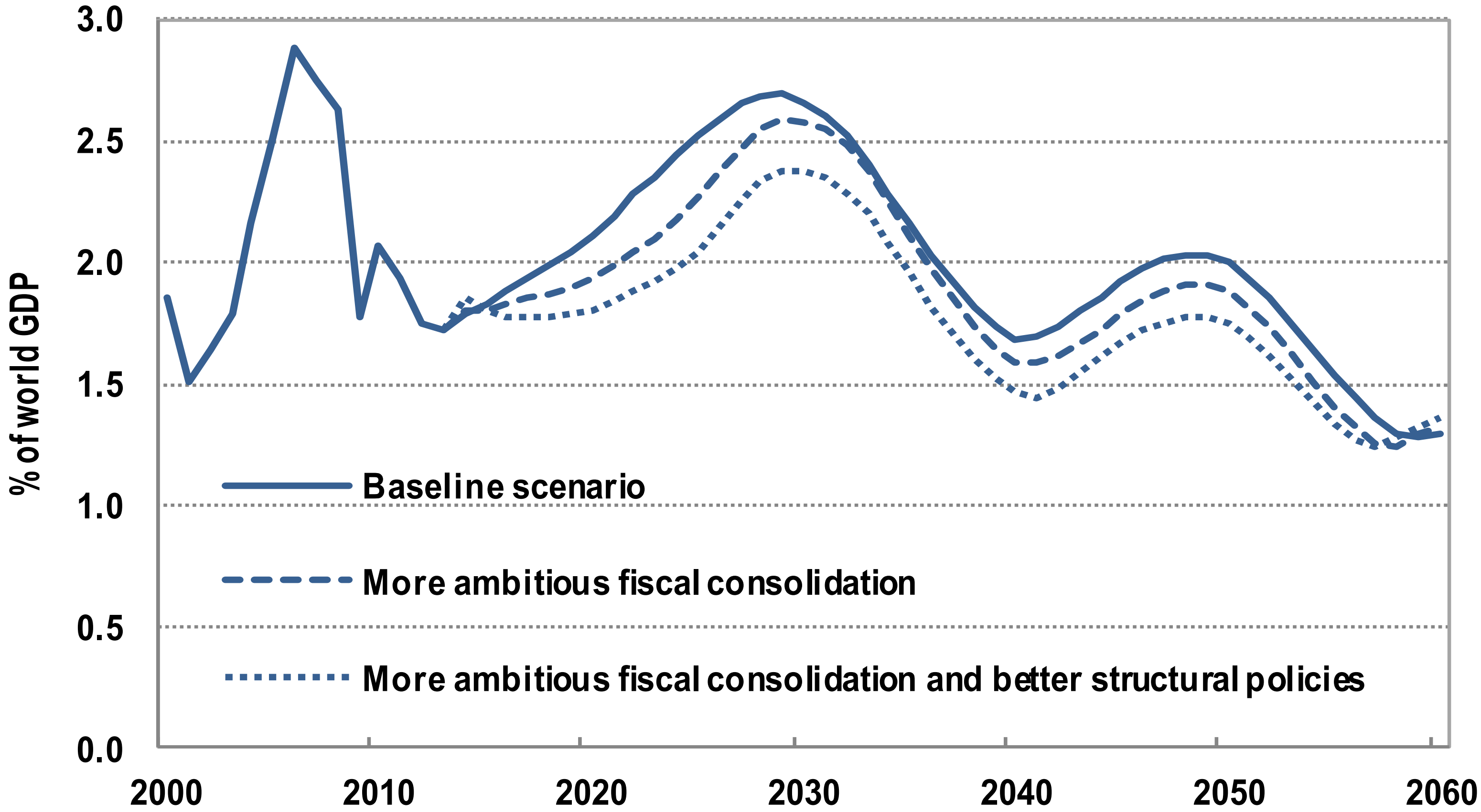
Structural reforms and more ambitious fiscal consolidation raise GDP

Differences from baseline in the potential growth rate
EME growth rates decline with catching up, less with policy action.
ADV growth rates stabilize at higher levels with policy action



Policy action can reduce global imbalances

Sum of current account balances in absolute value divided by 2

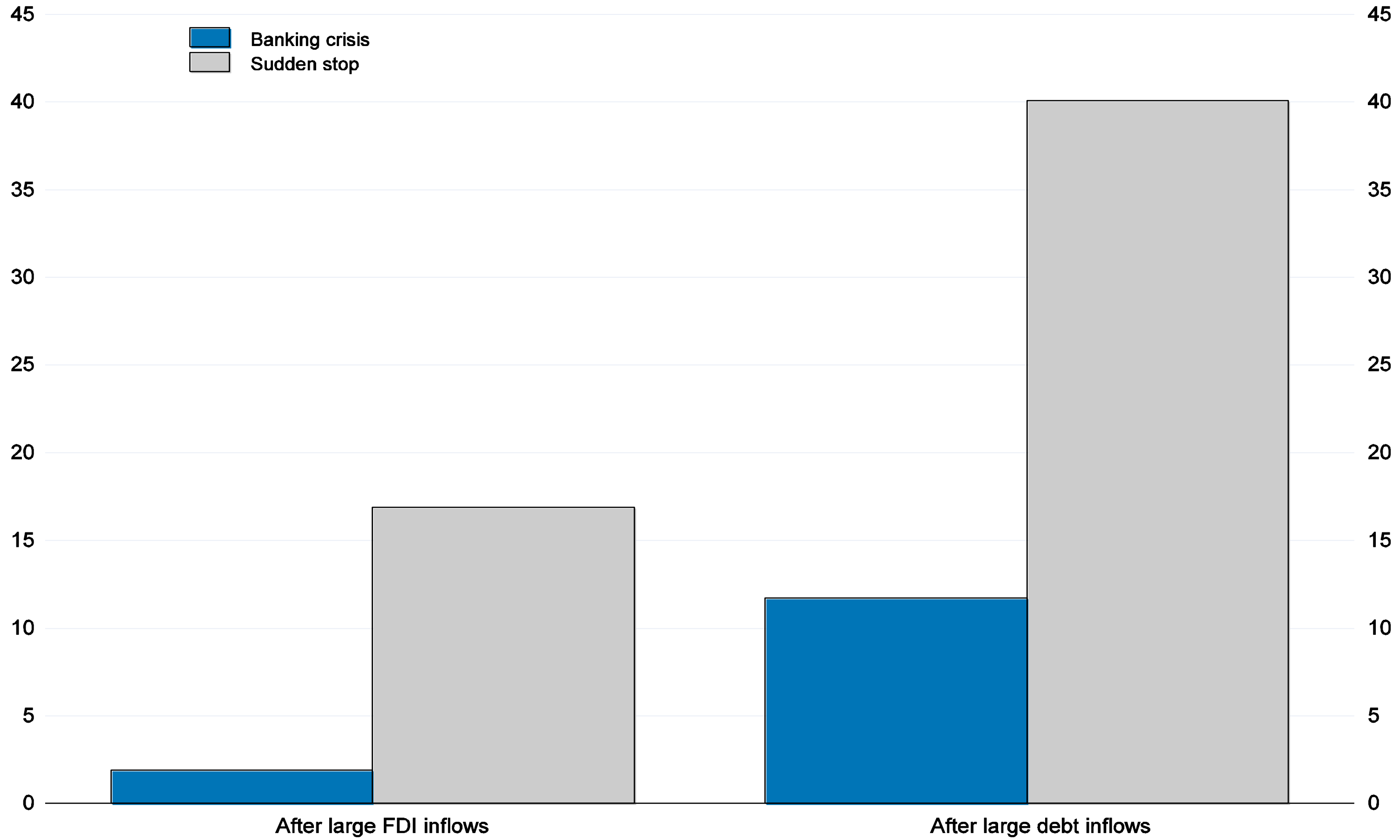


Structural policies reduce financial vulnerabilities

- Probability of crisis/sudden stop after large inflows is especially high when inflows are debt driven
- Debt-driven episodes of large capital inflows have a stronger impact on domestic credit than when driven primarily through FDI/equity portfolio investment
- Good *structural policies* are associated with a higher share of FDI and a lower share of debt

Capital flows and the likelihood of crisis

Annual probability of banking crisis and sudden stops, in per cent



Source: Furceri, D.,S. Guichard and E. Rusticelli (2011); and OECD calculations.

Long term growth perspectives

- **Growth of the non-OECD will continue to outpace the OECD, but the difference will narrow substantially over coming decades.** From over 7% pa over the last decade, non-OECD growth will decline to around 5% in the 2020s and to about half that by the 2050s.

- **The next 50 years will see major changes in the relative size of world economies**. Fast growth in China and India will make their combined GDP, measured at 2005 Purchasing Power Parities (PPPs), go from adding up to less than half of the total output of the major seven OECD economies in 2010 to exceeding it around 2025.

- **Large GDP per capita differences will nonetheless persist in 2060.** Despite income per capita in the ten poorest economies quadrupling by 2060, and China, India and Indonesia experiencing a seven-fold increase, living standards in these countries and in a number of OECD countries (notably Southern European) will be 45% to 75% lower than in the leading countries in 2060.

Policies for post crisis

- **Trend growth for the OECD will recover from the crisis to average 1¾ to 2% per annum.** If the retirement age is indexed to gains in longevity most OECD countries can sustain the growth in GDP per capita that has been experienced in previous decades, despite population ageing. Nevertheless, participation will still decline in many countries and so act as a drag on growth, unless bold labour market reforms are implemented.
- **In the absence of more ambitious policy changes, imbalances will emerge which could undermine growth.** Firstly, as the current cycle unwinds, the scale of global current account imbalances may increase and return to pre-crisis peaks by 2030. Secondly, government indebtedness among many OECD countries will exceed thresholds at which there is evidence of adverse effects on interest rates and growth. Thirdly, global interest rates may start to rise over the long-term.
- **Structural reforms deliver:** stronger growth, more manageable imbalances (domestic and international) reduced international financial fragility
- **More ambitious long-term fiscal consolidation among OECD countries can help**: by reducing country-specific fiscal risk premia; by helping to relieve global current account imbalances; and by boosting global savings and hence reduce pressures on global interest rates. Lowering government indebtedness would also reduce vulnerability to any future decline in global saving whether due to ageing or other factors.

Policies for post crisis (cont.)

- **Deep structural policy reforms could raise long-run living standards by about 16% on average across countries relative to a scenario of milder policy improvements.** Ambitious product market reforms, which are found to play a role in the convergence of technical progress, could increase GDP by an average of about 9%. Moreover, policies that induce convergence towards best practice labour force participation could increase GDP by more than 7% on average, with much larger effects in some countries.

- **Together, ambitious fiscal consolidation efforts and deep structural reforms can both raise long-run living standards and reduce the risks of major disruptions to growth by mitigating global imbalances**, raising aggregate OECD GDP by 10% and non-OECD GDP by 17%, with much larger effects in countries where policy lags most behind best practice.

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Summing up

- The immediate challenge for policy makers is to restore confidence by tackling unresolved issues in the US and the Euro area
- Confidence building is necessary to allow the global economy to move towards a more sustained and sustainable growth path
- Long term growth and sustainability will require decisive action in terms of structural policies and fiscal consolidation