STRENGTHENING ECONOMIC RESILIENCE:

INSIGHTS FROM THE POST-1970 RECORD OF SEVERE RECESSIONS AND FINANCIAL CRISES

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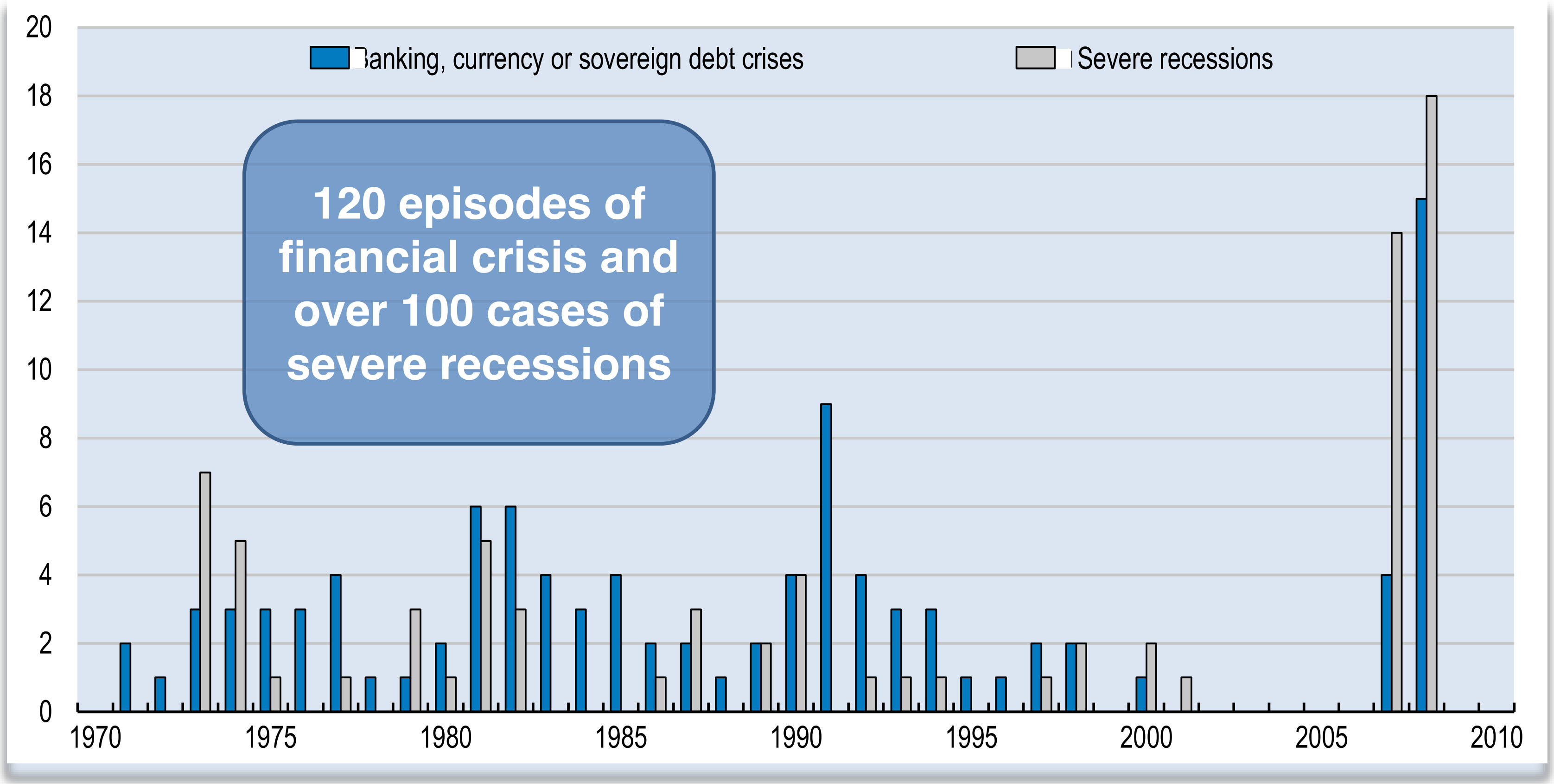
BETTER POLICIES FOR BETTER LIVES

Financial crises and deep recessions have been frequent

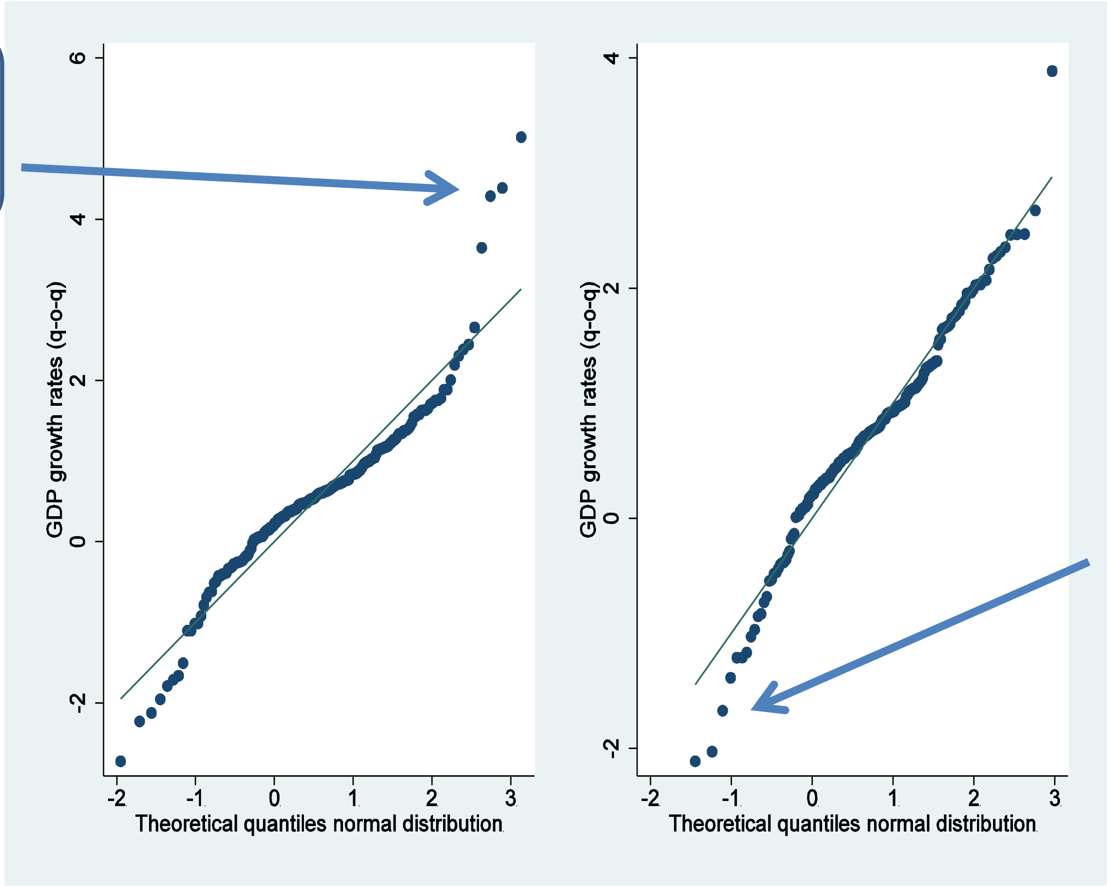
Number of OECD countries affected during each episode



Note: The chart refers to crisis and severe recession episodes for 35 OECD countries over the period 1970Q1-2010Q4. Crisis episodes are from Babecky et al. (2012).
Source: OECD calculations based on Babecky et al. (2012) data and Hermansen and Röhn (2015) for severe recessions.

Extreme negative growth events not uncommon... But booms common too.

Extreme positive growth rates



Extreme negative growth rates

United Kingdom

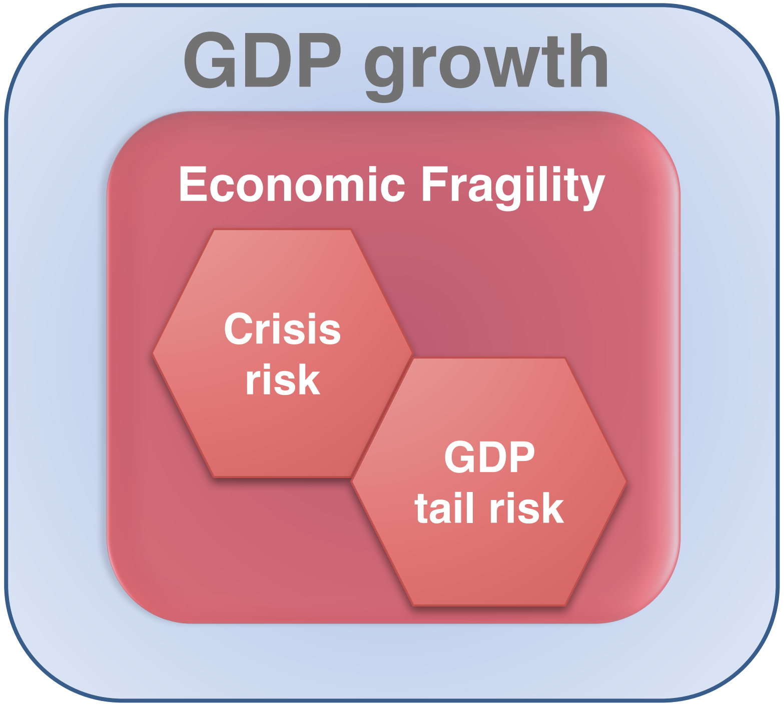
United States

Assess policies in a Growth-Fragility Framework

- Risk-mitigation need to be balanced against potential cost of
  - eliminating booms
  - reducing mean growth

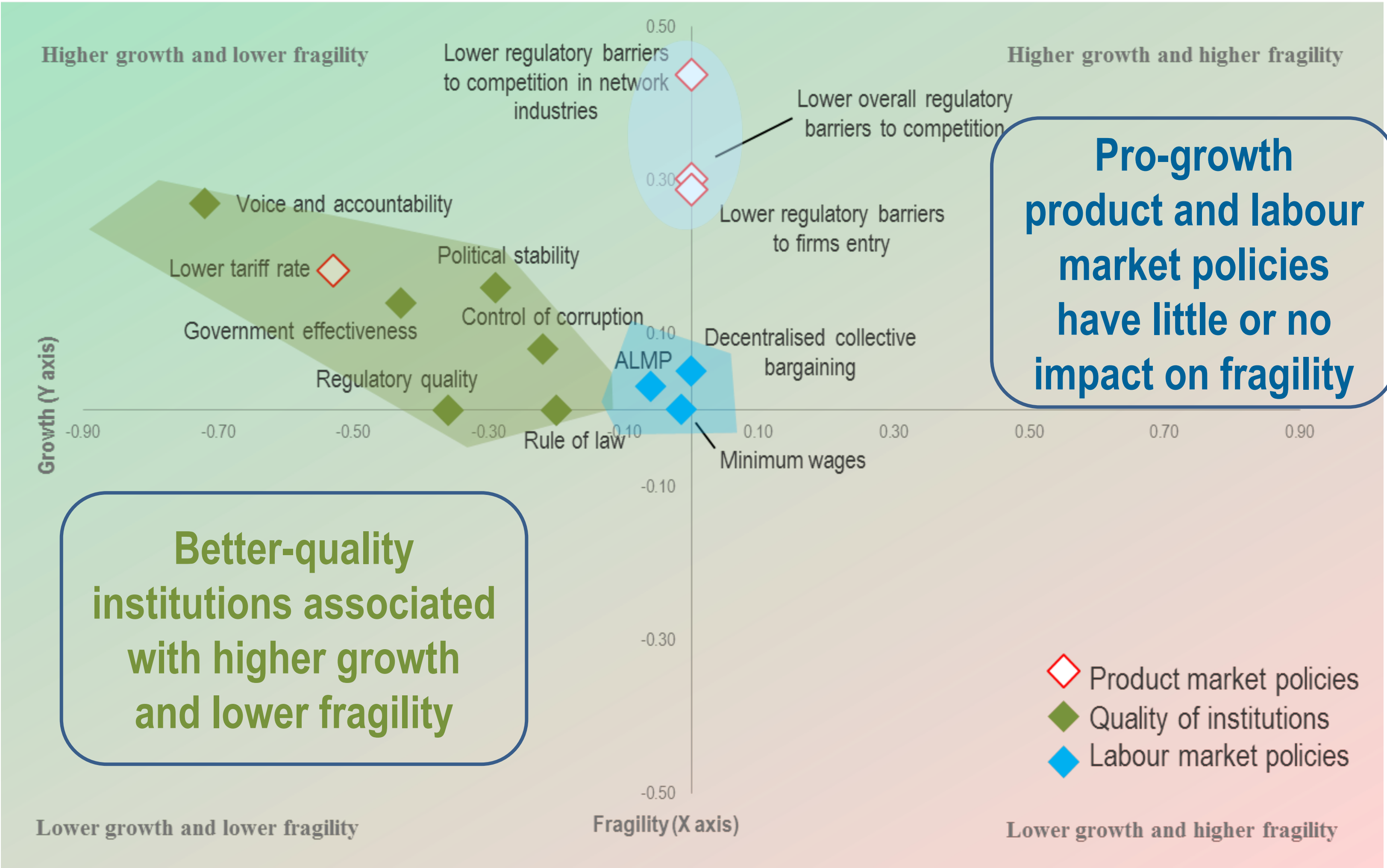
- *Banking crisis*
- *Currency crisis*
- *Twin crisis*

Policies and probability of crisis vs GDP growth



Policies and extreme negative GDP growth rates vs mean GDP growth

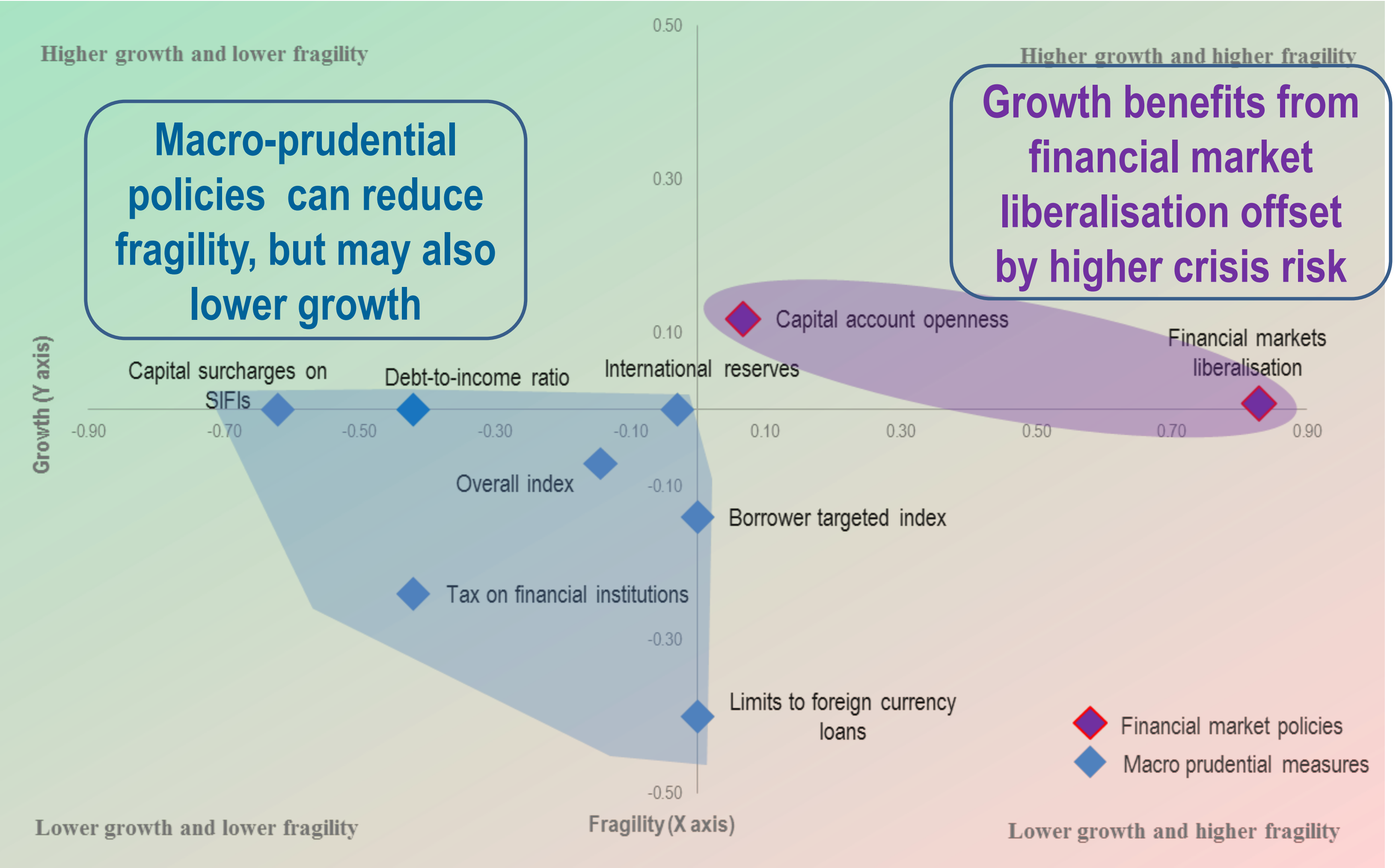
Policy areas outside the financial sector do not involve growth-fragility trade-offs



The X axis plots the effect on fragility; Fragility is defined as higher likelihood of financial crises (polices with red outline) or a higher GDP (negative) tail risk. Three types of financial crises are considered: Currency, banking and twin crises. Tail risk is defined as the effect on the bottom 10% of the distribution for quarterly GDP growth. For each policy, the Y axis plots the average (overall) growth effect.

Source: Authors' calculation based on Caldera Sánchez and Gori and by Caldera Sánchez and Röhn, forthcoming OECD working paper.

More trade-offs are found in the area of financial market policies



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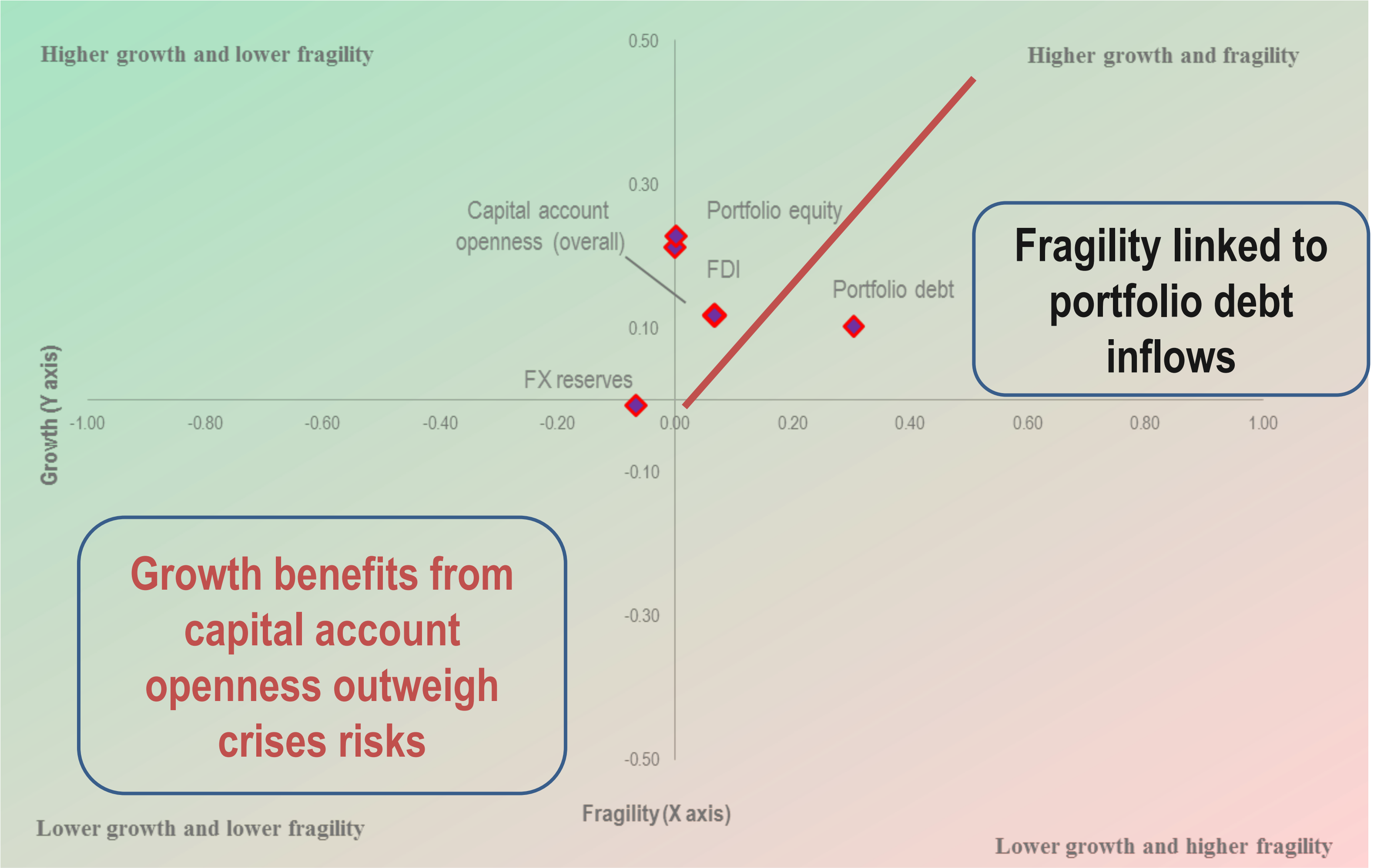
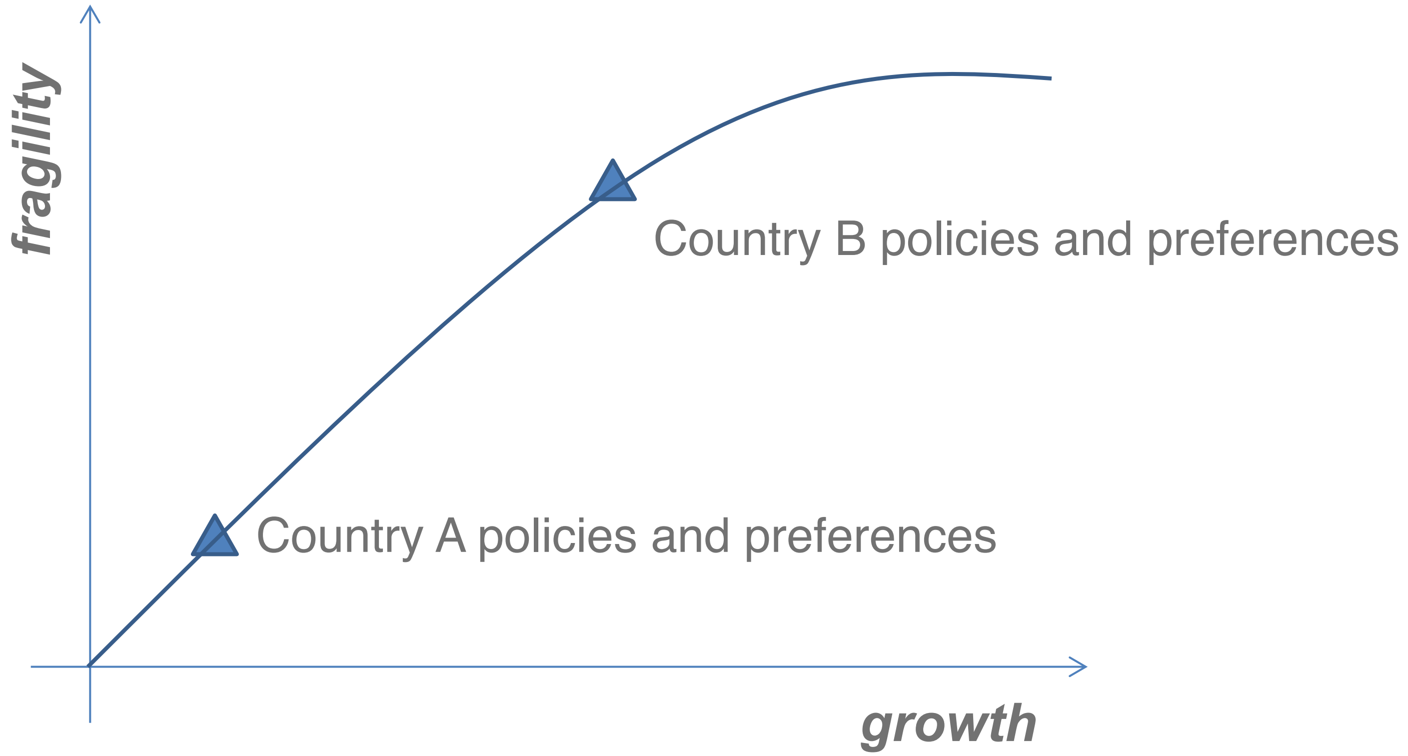
Capital account openness increases both growth and economic fragility..

Composition of capital flows matters



Why international cooperation matters in a world of global capital



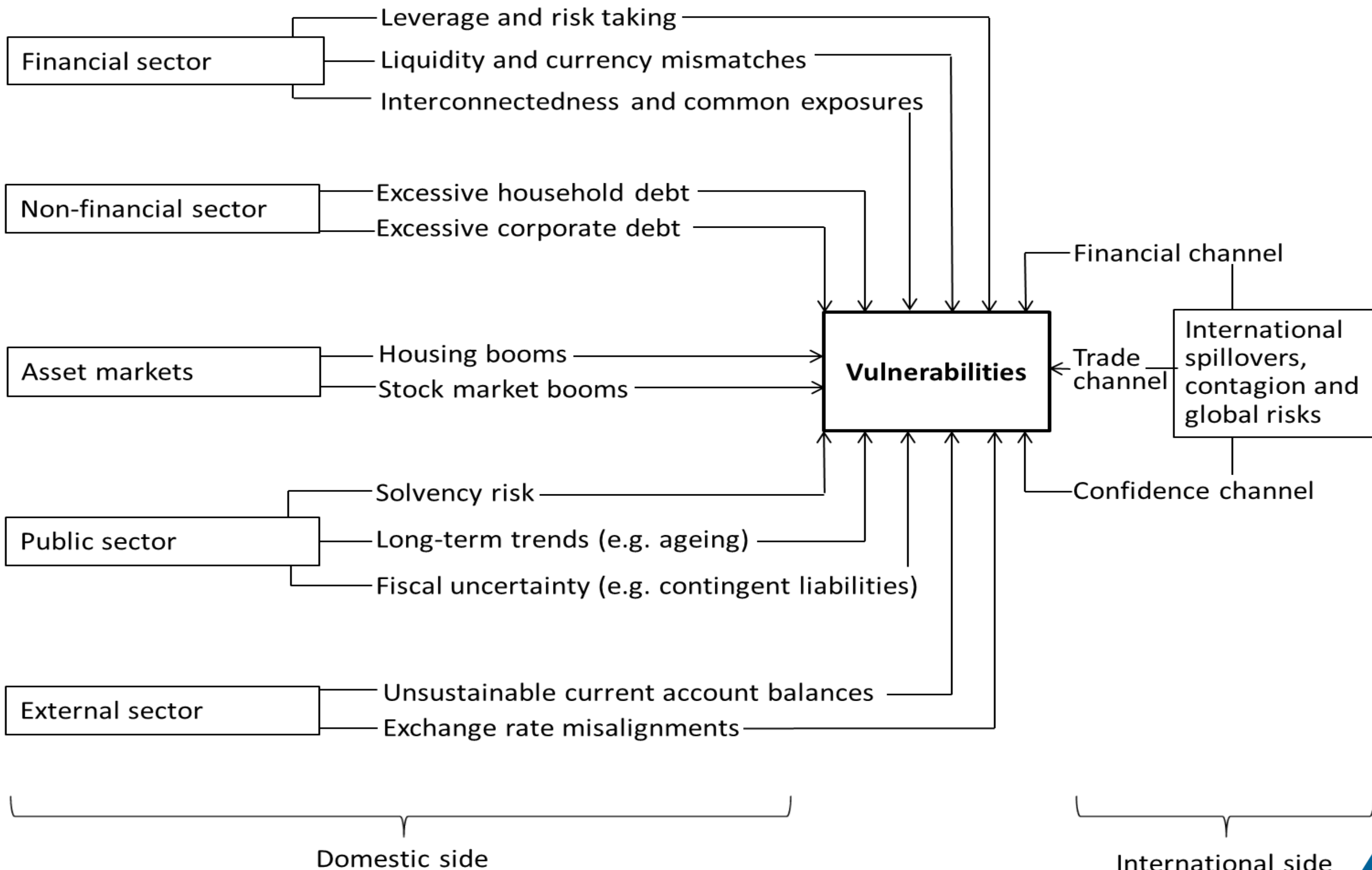
What do these results mean for policy?

- **Financial sector measures are appropriate *but:***
  - Unlikely to be sufficient to avoid fragility
  - Policy choices could reduce mean GDP growth

- **Distortions outside the sector need to be addressed:**
  - Pro-growth product and labour market policies affect mean growth, but not sufficient to reduce fragility.
  - Some distortions may be difficult to capture in the growth-fragility framework

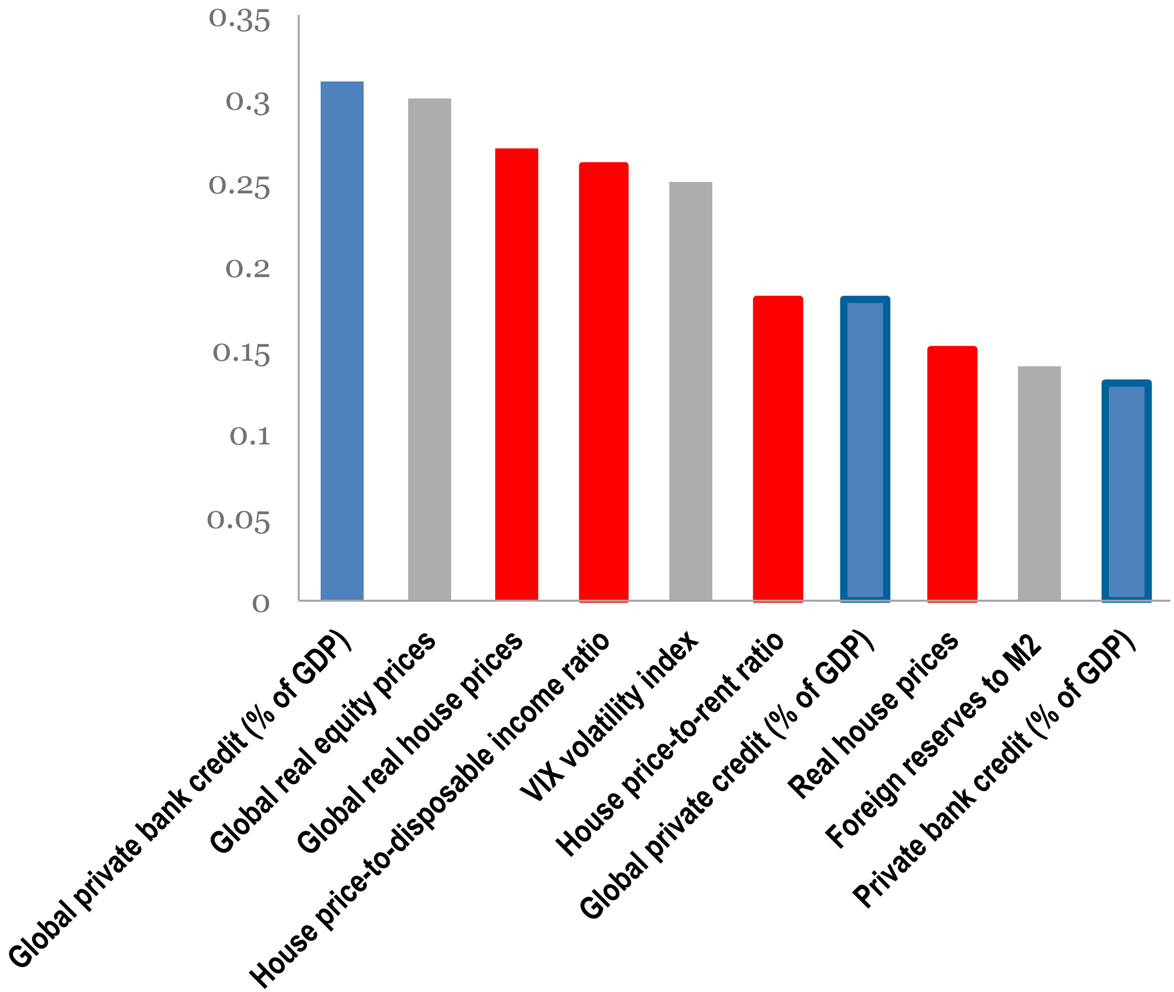
- **What types of imbalances are associated with fragility?**
  - Analysis based on early warnings of recessions provides insight

A large set of indicators to detect potential threats to financial stability



Source: Röhn et al., 2015, ""Economic resilience: A new set of vulnerability indicators for OECD countries"

Some indicators are better than others at signalling severe recessions



Two areas dominate the top ten:

⇒ Private credit-related indicators :

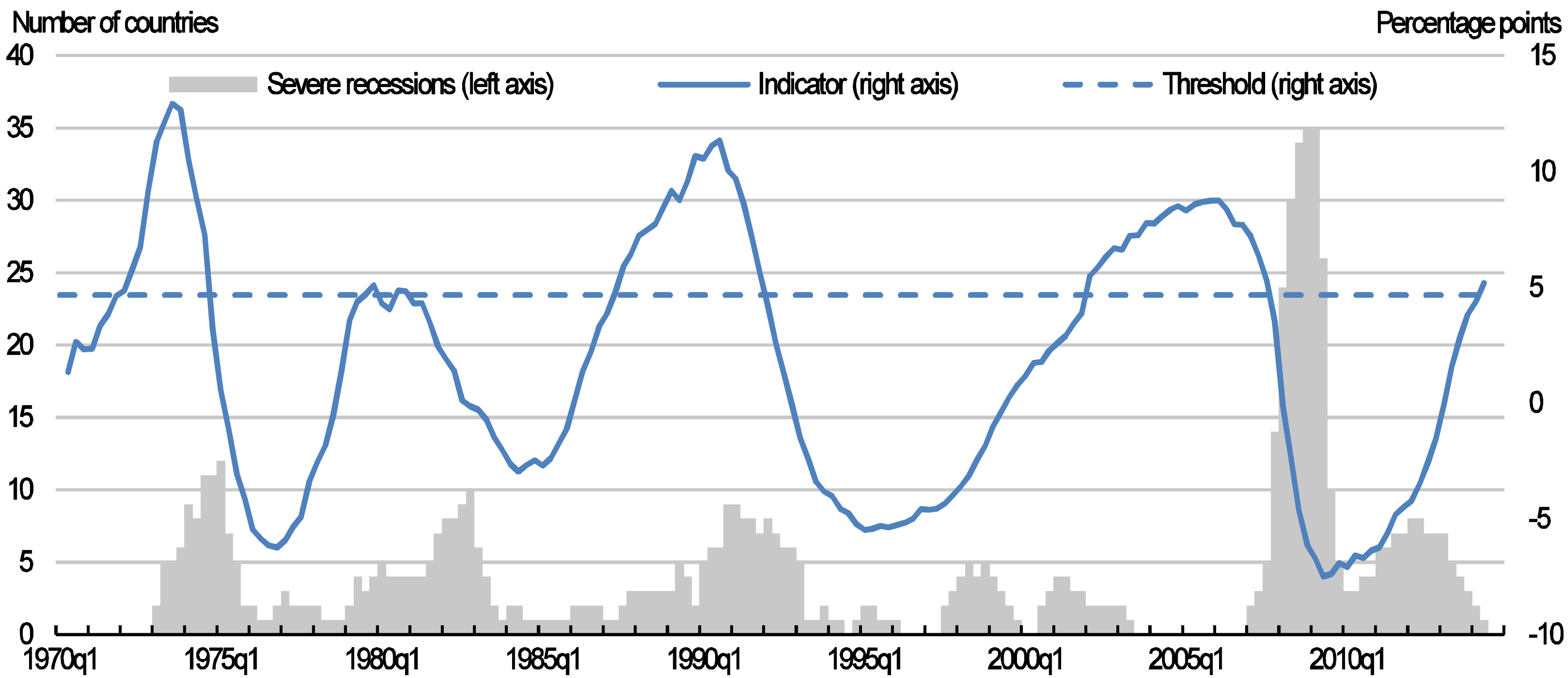
⇒ Housing market-related indicators:

Source: Hermansen and Röhn, 2015

Housing price cycles often associated with severe recessions

Tax biases and regulations exacerbate tensions between inelastic supply of housing and elastic lending capacity.

Global real house price index, p.p. deviation from trend

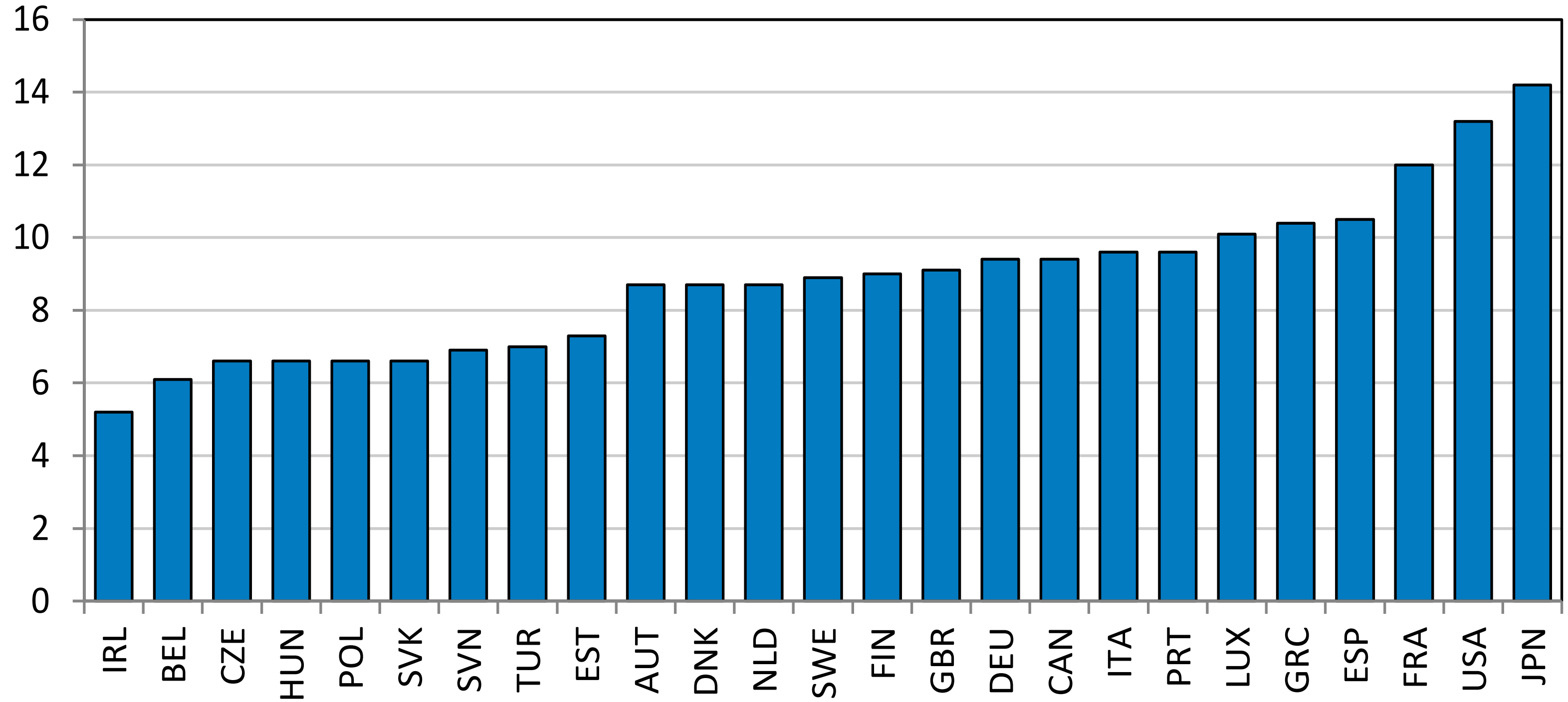


Source: Hermansen and Röhn, 2016

Corporate tax systems favour debt over equity finance

Such tax bias associated with higher share of debt in external financing, increasing financial risk.

Percentage point difference between tax rates on equity and debt finance, 2011



Source: Cournède et al., 2015

Concluding Observations

- **Product and labour market policies**
  - Enhance growth, little impact on crisis risk.
- **Financial market liberalisation**
  - Pro-growth impact of reduced by crisis risks, which are driven by

    => *Excess private credit growth*

    => *Misalignments in real estate markets*
- **Capital account openness**
  - Pro-growth effects of greater outweigh crisis risk

    => *Risk mainly associated with portfolio debt flows*.

- **Macro prudential necessary but not sufficient (and may entail costs). Need support from other policy areas:**

  ⇒ **Reducing the tax bias towards corporate debt**

  ⇒ **Reducing tax bias towards ownership and debt financing in housing**

  ⇒ **Reforming land use regulation**

  ⇒ **Lowering barriers to FDI**

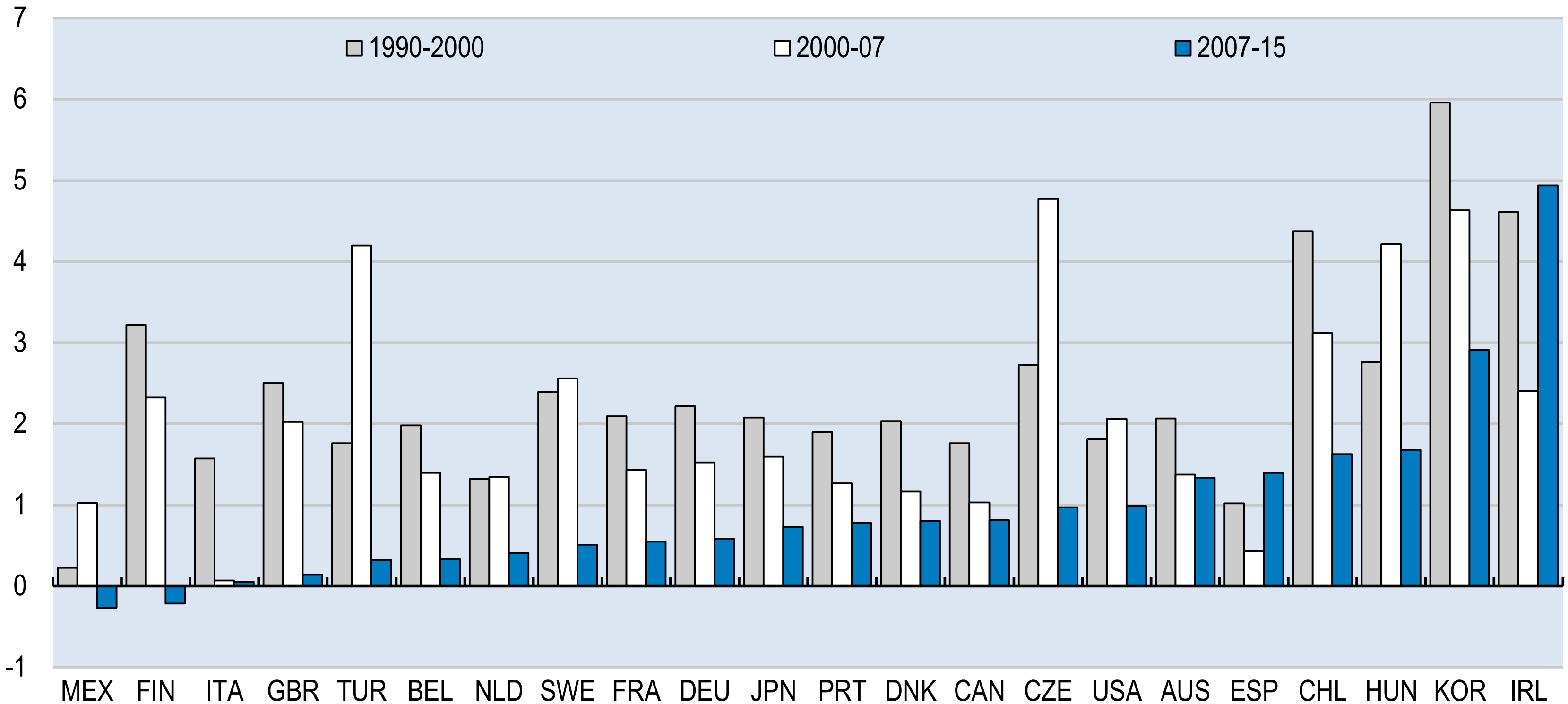
OECD Resilience website

http://www.oecd.org/economy/growth/economic-resilience.htm

Prepared by Alain de Serres and Filippo Gori

The 2008-08 crisis was by far the most widespread and costly

Average annual growth rate in GDP per hour worked, percentage



One legacy is the sharp productivity slowdown in many countries, in particular across Europe.

Contrasted performance of different policies

MACROECONOMIC POLICIES

- strong automatic stabilisers

  → less extreme growth shocks, but comes at a price of lower average growth

FINANCIAL MARKET CHARACTERISTICS

- **effective prudential banking supervision, developed capital markets**

  → less severe negative growth shocks (+) and higher growth (+)

MACROPRUDENTIAL POLICIES

- **Debt-income caps, counter-cyclical capital buffers, capital surcharges on SIFIs**

  → strongly or moderately reduces negative tail risk (+) and little or no effect on average growth

- **Loan-to-value caps, taxes on financial institutions, limits to foreign-currency loans**

  → little or no effect on negative tail risk and lower average growth (-)

LABOUR MARKET CHARACTERISTICS

- higher spending in active labour market policies

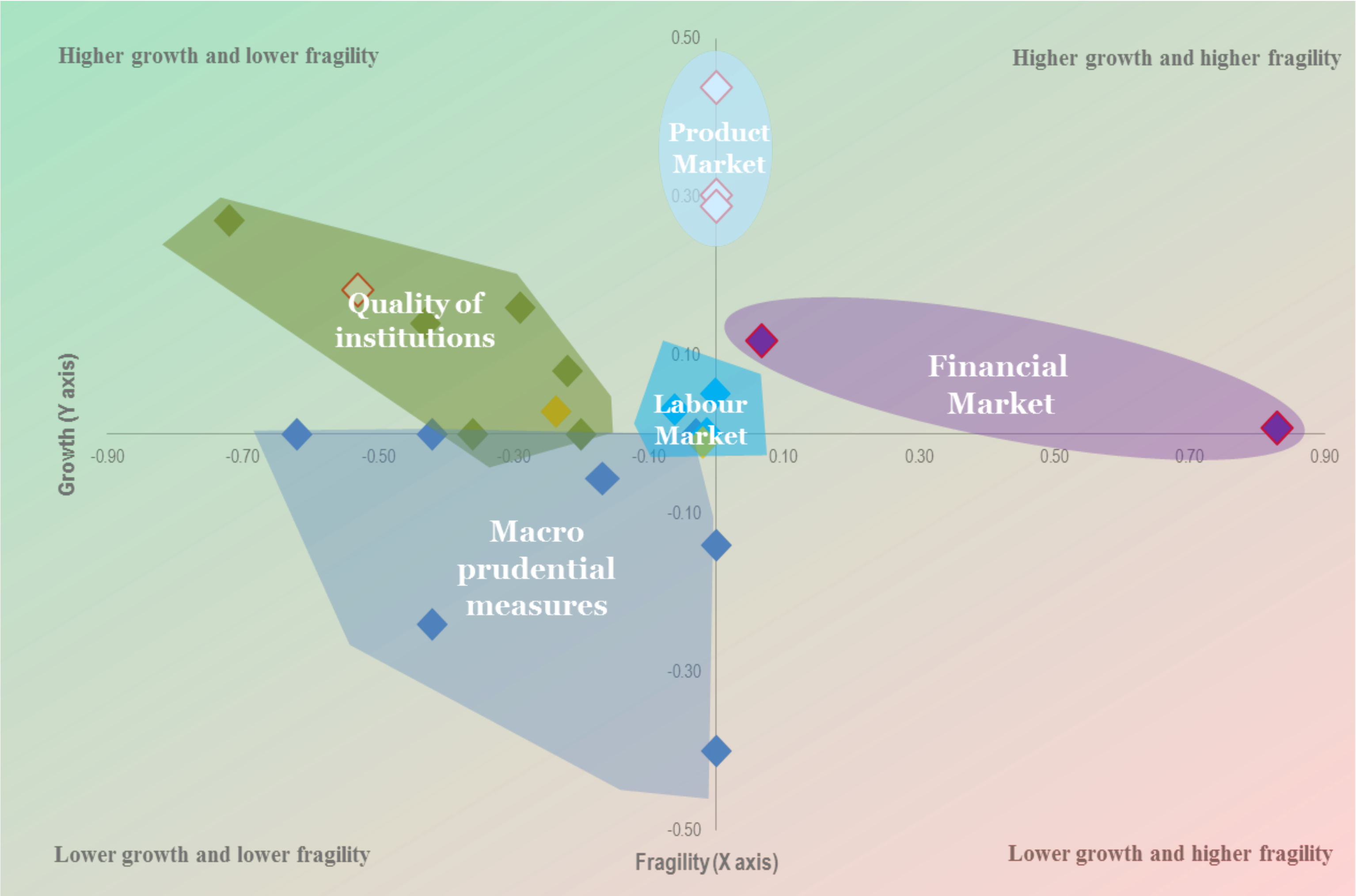
  → less severe negative growth shocks

EXTERNAL POLICIES

- higher accumulation of international reserves

  → less severe negative growth shocks

Summary of the effect of policies on growth and stability



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