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HOW DEEP IS A CRISIS? POLICY RESPONSES AND STRUCTURAL FACTORS BEHIND DIVERGING PERFORMANCES

Jean-Paul Fitoussi Francesco Saraceno

November 15, 2009

Abstract

The effects of the current crisis on the level of output, and consequently on unemployment and poverty are deep and long lasting; they should not be underestimated, especially now that some timid signs of recovery are appearing. The crisis was triggered by the US financial sector, but its roots are real, and can be traced to the deepening income inequality of the last three decades, that led to a chronic deficiency of aggregate demand. In the Unites States, the center of the crisis, the policy reaction was bold, and as a consequence the effects of the crisis are less important than in the eurozone, where only France has a comparable performance. The policy inertia of the eurozone countries, in fact, is more structural, and is related to the institutions for the economic governance of Europe. The statute of the ECB and the SGP, that reflect the doctrine opposed to discretionary macroeconomic policies, constrain eurozone governments, and monetary policy. The relatively better performance of France can in fact be explained with these lenses because on one side it has a well developed system of automatic stabilizers, and on the other it suffered less than other OECD countries of the deepening inequality. Developing countries, that suffer from a crisis that they did not originate, should be given the means to carry on policies to contrast the crisis, avoid pauperization and long term negative effects of the adverse shock they experienced

1. Introduction

The debate is raging between those who think that the crisis is now behind us and those who believe that it is still before us. One of the reasons of the debate, besides the doctrinal one, is that the two camps are not looking at the same statistics, nor speaking of the same thing while using the same words. The former one is looking at the *change* in flows (the rate of growth of GDP) and at the level of the stock of public debt. The first is becoming positive almost everywhere, hence their conclusion that the crisis is behind us; the second has grown to fairly high level which according to them legitimates the call for an “exit strategy”, by which they mean the progressive withdrawal of the state from its sudden intrusion in “economic affairs”, in particular by decreasing its spending. In sum, the crisis was just a parenthesis, and there is no reason why the world after it would not resemble the world before. Looking at the (non) decisions taken at the several G’s meeting, this stream of thought seems to dominate the scene. At the national level, its domination is reflected by the noise made around the urgency of beginning *now* to curb public debt and deficit, and by the emphasis put on the positive signs on the front of growth.

The second camp is focusing its attention on the *levels* of flow (GDP, GDP per capita, and output gaps), at the stock of unemployed, at the poverty rate (the stock of poor) and at the

wealth of Nations. Seen from this perspective, the situation does not look very healthy. On average in OECD countries, the level of GDP is now about 400 basic points lower from what it was in 2008, and the large countries are doing even worse (see Figure 1). Output gaps have reached such a high level that it would take several years before closing them. In most developing countries the situation is similar, if not worse. For these countries, especially those which have followed a strategy of openness, the situation is all the more dramatic that world exports have decreased by about 30% between October 2008 and July 2009. But the most dramatic feature inherited from the crisis is unemployment: since the first quarter of 2008, unemployment has increased by 7.4 millions persons in the US, by 1.2 million in Japan and by almost 6 millions in the European Union. At the world level it has increased by 50 millions while the number of persons in absolute poverty increased by about 200 millions. Even worse, we may infer from the level of the output gap that those numbers are going to growth at least for the year to come.

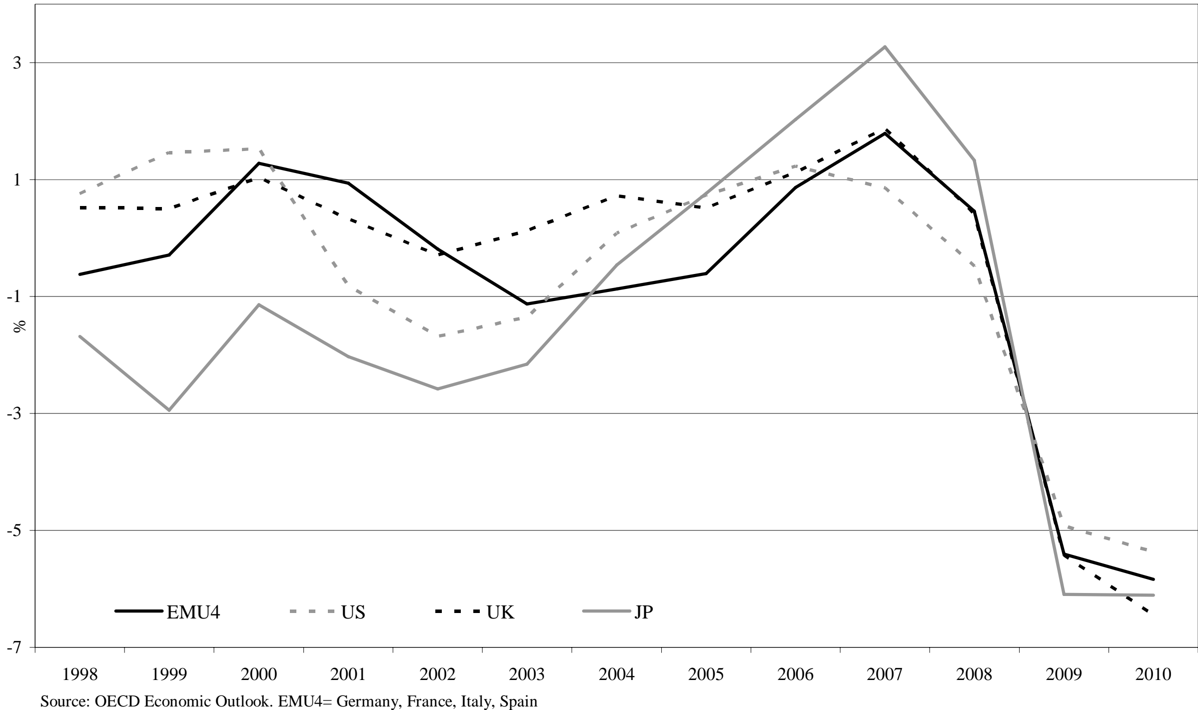

Figure 1 - Output Gap

Hence, when looking at flow's level and at the relevant stocks –those which matters the most for the people –, we are far away from having outpaced the crisis. Compared with the pre-crisis situation, the present one appears as one where on average people are less wealthy, have a lower income, a higher probability of being unemployed etc. In short their well being has strongly decreased. The only strategy which matters is an exit strategy from the crisis, not from the hands-on policy that the governments have followed with diverse fortune. In what follows, our inclination lies without any ambiguity towards the second interpretation of the present situation: in a context where unemployment is expected to growth further and to recede only slowly after having reached its climax– that is where during a rather long period the rate of unemployment will be very high by historical standard – it could hardly have been different...

In what follows, we will take successively a global view (section 2), an European one (section 3) and a French one (section 4). We will conclude by highlighting the situation of developing and emerging countries and the policies they should conduct with the help of the international community (section 4).

2. The Impact of the Crisis and the Perspectives for Recovery

At least since Wicksell and Keynes we know that most of the disequilibria in the real economy originate in the financial sector. For example we understood that unemployment is more often the consequence of too high a level of real interest rates, than of too high wages. This should not, however, lead to think of these disequilibria as being exogenous to the real economy. When confronted with a malfunctioning of this magnitude of the financial sector, we need to ask how this malfunctioning originates in the interaction with the real sector. Many stories may be told, but in a nutshell, the one we believe has much to recommend to it is the following: at the outset there is an increase in inequalities which depressed aggregate demand and prompted monetary policy to react by maintaining a low level of interest rate which itself allowed private debt to increase beyond sustainable levels. On the other hand the search for high-return investment by those who benefited from the increase in inequalities led to the emergence of bubbles. Net wealth became overvalued, and high asset prices gave the false impression that high levels of debt were sustainable. The crisis revealed itself when the bubbles exploded, and net wealth returned to normal level. So although the crisis may have emerged in the financial sector, its roots are much deeper and lie in a structural change in income distribution that had been going on for twenty-five years. From this perspective, what caused the crisis has been building up endogenously (Stiglitz *et al.*, (2009)).

Between the end of 2008 and the beginning of 2009 the world economy experienced the most severe recession in decades. The excessive losses linked to subprime mortgages and to related derivative market severely disrupted the financial sector (leading to a near-collapse of the interbank market in the fall of 2007) and triggered a race to deleveraging and to the accumulation of safe assets by financial institutions, firms and households alike. The most obvious effect of this flight to safety has been a severe tightening of credit conditions, that constituted the main (albeit not the only one) channel for the transmission of the crisis to the real sector. The credit crunch was further deepened by the drastic fall in the value of financial assets, used among other things as collateral in fund raising by firms and households. Through decreased trade and exports the crisis quickly spread from the US to other countries, even those which had kept their financial sector healthier.

Emerging countries not only were unable to compensate for the crisis of developed countries, thus proving the theories of decoupling to be far too optimistic. They were actually hit harder, as all their structural fragilities were exposed by the crisis. Oil and raw materials exporting countries suffered from the fast fall of prices, and manufacturing goods exporters were penalized by the unprecedented drop in world trade. Furthermore, the increased risk aversion of international investors reduced investment in emerging countries, and caused capital flights and pressure on the exchange rates, further increasing the debt burden for households and firms in these countries.

The downward spiral lasted at least two quarters, the last of 2008 and the first of 2009, with violence unseen since the thirties. True, some signs of reversal started to appear (at least in some countries) in the second and third quarters of 2009. But the cause of this reversal may be traced back to strong policy action that supported aggregate demand both directly and through a positive effect on private sector's expectations and spending. Figure 2 shows GDP growth figures and forecasts for 2009-2010 (OFCE, (2009)).

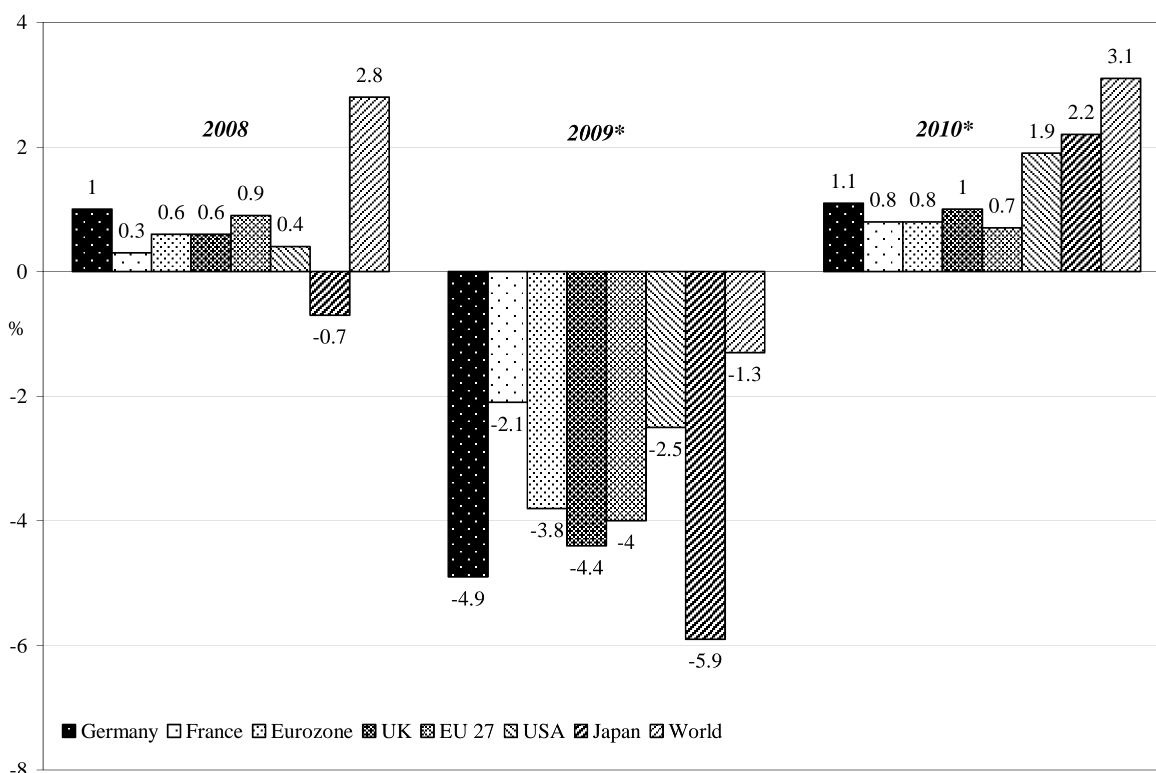

Figure 2 - GDP Growth

From the figure it can be noted that in spite of the weak recovery currently under way, the overall decrease in GDP in 2009 remains historically high. Furthermore, for the same year, European countries, with the exception of France, seem to be suffering more than the US from the crisis. This finding is somewhat puzzling as the US is considered as the epicenter of the crisis. We will explore the point further in the next section.

The green shots of recovery nevertheless, do not make room for excessive optimism. Each of the economic actors has cumulated old and new fragilities that explain why growth in the future should remain modest. *Banks and financial institutions* are recovering[1], as witnessed by the normalization of interbank markets in terms of volumes and spreads. Nevertheless, the health of their balance sheets is not yet clear, also because to the losses linked to the financial crisis have to be added those imposed by the current contraction of economic activity, whose extent cannot be fully appreciated yet. Investment by *firms* is not to be expected to boom in the short-to-medium run either, because even if credit conditions will revert to normal again (which remains to be seen), the crisis has left many firms with excess capacity, and bankruptcies give the possibility to acquire capital at low cost without fresh investment. Finally, *households* have experienced a serious negative wealth effect, caused by the sharp decrease of stock and housing values since 2007. This contractionary effect on disposable income and consumption is strengthened by the credit crunch, and even more importantly by the increase of unemployment that is following with a lag the contraction of GDP, and that is forecasted to keep increasing well into 2010. That is of a great concern: if it is true that one of the causes of the deficiency in global demand and thus of the crisis is the increase in inequalities that took place in most countries in the last quarter of a century, the

[1] This fast recovery may signal a worsening of the moral hazard problem. The bailing out of banks has been done in such a way (almost without conditionalities) that it has increased the certainty of the actors that they were too big to fail, especially because thy have taken advantage of the process to become even bigger. Moreover, the bail outs and the fast recovery have further increased the feeling of unfairness of the population.

expansion of unemployment and of job precariousness makes the present state of inequality worse than what it was at the eve of the crisis. Finally, the stimulus plans and the working of automatic stabilizers have seriously deteriorated government finances. We cannot exclude that some governments will try to invert this trend in the next year or so, thus contributing to suffocate the recovery under way: as the recovery owes more to the oxygen tent built by governments than to the capacity of capitalism to self regulate, it will be foolish to withdraw the tent.

All of these factors explain why the forecasts for 2010 reported in Figure 2 remain well below potential for all the countries considered, and that a prolonged period of deflationary pressure is still a possible future scenario.

3. Why has the Crisis Hit Harder Europe than the US?

At the early stages of the crisis it was expected that Europe would be less hit than the US, as the crisis was traced to the excessive activism of macroeconomic policies (in particular monetary policy) of the Unites States, combined with excessive deregulation of financial markets. Europe, we were told, would not suffer from the same fate because its growth model was based on strong regulation and prudent macroeconomic policies.

But, in fact, financial globalization had already accomplished its work: the world market was simply localized in the US, and all the financial actors mainly from the rich countries played on this market spreading the toxic assets all over the world. Hence, even if the number of spectacular bankruptcies in Europe was limited, the banking sector proved to be as fragile as the American one. The consequence is that the chaining of events is extremely similar, even in size, across the ocean: banking sector insolvencies, confidence crisis, drying up of interbank markets, flight to safety and asset depreciation, negative wealth effects and credit crunch, drastic private spending reduction.

In particular, the argument that prudent macroeconomic management was the winning strategy proved to be flawed, and it actually has to be reversed if we want to explain the apparent paradox of a crisis that hits harder the eurozone than the US. As happened virtually in all occasions since the early 1990s, The US fiscal and monetary policies were more reactive to the shock, and this major difference (in timing and size) is the only major difference that can be observed in the past twelve months. We have argued elsewhere (Fitoussi and Saraceno, (2004)) that the set of institutions for the economic governance of Europe is consistent with the doctrine that dominated in the 1990s, that pledged for a rule-based system aimed at preventing discretionary interventions and at pursuing nominal stability, because the growth objective would be attained through structural reforms alone. The Stability and Growth Pact (SGP) and the strict inflation targeting contained in the statute of the European Central Bank (ECB) did in fact succeed in attaining nominal stability and convergence (Fitoussi and Laurent, (2009)). But, not surprisingly, this came at the price of two decades of soft growth that could have been easily forecasted, had the dominant theory not failed to take into account the tradeoffs implied in the exclusive focus on nominal stability (Fitoussi and Saraceno, (2004)). Moreover the emphasis on structural reforms constrained European governments to engage in non cooperative strategy through fiscal and social competition.

We discussed elsewhere the effects of excessively restrictive macroeconomic policies in the eurozone countries during the recessions of the early 1990s and more recently of 2001, comparing them to the strategy followed by American policy makers (Fitoussi, (1996; 2001)). Before showing that the current crisis constitutes no exception, we would like to make a final general remark. In principle, a proactive macroeconomic policy is not a necessity. An economic system endowed with strong social safety nets and a well functioning system of

automatic stabilizers would be able to cushion the negative effects of shocks without resorting to discretionary measures. In fact, the proactive macroeconomic policies followed in the US, by republican and democrat administrations alike, are necessary for a system that made the political choice of minimizing social safety nets: in bad times, policy restrain would cause large swings in employment and income, thus inflicting unbearable pain to society, and potentially leading to social unrest. In other words the US system is the result of a political and democratic choice, and within that choice it is consistent. Equally consistent would be a system in which the restraint in macroeconomic policies went hand in hand with a strong welfare system and an important role for automatic stabilization. This issue seemed to be clear at the time of the debate on the SGP when, in response to criticism the proponents of the Pact argued that constraining discretionary choice would not be a problem because room was left for automatic stabilization to operate (look for example at Buti and Giudice, (2002) who reflected not only the general view of European economists but the political position of France and Germany). The problem is that, as we said above, in the EU the constraints to macroeconomic policies were coupled with increasing emphasis on structural reforms and on the necessity of downsizing the welfare state. Creel and Saraceno, (2009) show how the role of automatic stabilization and of social protection has been constantly decreasing over time, both in the EU and in the US; but only in the latter the role of macroeconomic policy has been proactive, as would have been consistent with this trend. This fundamental inconsistency is in our opinion at the roots of the poor macroeconomic performance of the EU, when we compare it with the US.

Monetary Policy and the Subprime Crisis

In the early phase of the crisis, the losses linked to the subprime mortgages could have been easily absorbed by the system with losses limited to the imprudent lenders. But these mortgages had been the heart of a chain of financial innovations that multiplied the effects of the initial shock. The original lenders had been packaging the mortgages into high yield securities that were supposed to reduce the risk because of the lack of correlation between their components, and the dispersion of risks over a multitude of investors.

When the housing market slowed down, mortgages that would be viable only because the price of the collateral they were based upon was increasing, became “toxic”. The sources for refinancing households dried, and lenders driven to sell collateral of defaulting borrowers had to do it at very low prices, that imposed large losses. Risks turned out to be correlated, and their scattering through securization, instead of being a source of safety, was the vehicle for spreading the infection to the whole system. Since the summer of 2007, a defining feature of this crisis has been the deep uncertainty of financial institutions about their own health, and the health of their neighbors. This deep uncertainty made banks reticent to lend to each other, and the interbank market dried up. This forced central banks to intervene since August 2007, to refinance banks and to inject liquidity into the system.

The crisis quickly evolved in a vicious circle of deleveraging, as banks tried to sell their assets in order to buy safe (mostly public) debt, and stop the deterioration of their debt-to-capital ratio. But this race to sell further depressed prices and the value of their assets, thus worsening things even more.

The subprime crisis represents a typical case in which solvency and liquidity problems are difficult to disentangle. Nevertheless, it is almost unanimous opinion that in August-September 2007 the crisis was hitting the credit sector with no regard to actual solvability of the individual institutions, dramatically increasing the systemic risk. Thus, in spite of the difficulties for central banks to act as lenders of last resort in a context of increasing sophistication of the financial system, the praise for the early intervention of the Fed and the

ECB was unanimous. Nevertheless, this intervention took a very different form across the ocean.

The driving principles of the ECB action can be summarized as follows. Inflation is mainly a monetary phenomenon, and price stability has to be the priority, if not the sole objective, of central bank action[2]: in the classic assignment problem the instrument for controlling inflation is the interest rate. This essential and somewhat radical assumption explains the peculiar importance that money aggregates took in the initial strategy and communication of the ECB, and also the refusal to consider differences between headline and core inflation when assessing monetary conditions in the Euro area[3]. Other tasks, as for example ensuring liquidity of the banking sector, need to be addressed without hampering the main objective of price stability; thus, on one side interest rates cannot be used for other objectives, and on the other any other operation by the ECB needs not to affect the medium run target growth rate of money supply. It is why the focus on price stability through strict or flexible inflation targeting is neither a sufficient, nor a necessary condition of macroeconomic stability. Nevertheless, the solution of the assignment problem is flawed. You can separate economic objectives and assign to each a privileged instrument – the so-called Tinbergen-Mundell rule – if and only if the model of the economy is linear; otherwise all instruments should concur together to the different objectives.

During the crisis the ECB remained faithful to its credo. The key eurozone interest rates remained unchanged from June 2007 to July 2008 (at a level of 4%!), when the ECB *increased* them, because of the increase of energy prices; an error that raised doubts about its understanding of the real extent of the crisis. Only in the fall 2008, when it became clear that the threat was deflation and not inflation, the ECB began a series of rate decreases that in May 2009 brought the marginal lending facility rate and the REPO at their current level of 1.75% and 1% respectively (Figure 3).

The subprime crisis was primarily dealt with through short term refinancing operations, which provided the very short term liquidity that the system needed, without nevertheless increasing the long term amount of money.

The strategy pursued by the Fed was rather different. At least in an initial phase, the US central bank used the interest rate instrument to curb the interbank rates (LIBOR), and to inject liquidity into the system. The first reaction of the Fed was a reduction of the Primary Discount Rate, in order to narrow the band for short rates (The ECB did the same thing only in October 2008, for the 4 months to January 2009). Subsequently, the Fed cut all rates in five different occasions, keeping the window constant. Overall, Fed Funds target rates went down 225 points in 4 months, and were further lowered in the fall 2008 to the current level of 0.25% (the discount rate being 0.5%).

Late in the fall 2007, the Fed also turned more massively to open market operations, most notably through the creation in December 2007 of the Term Auction Facility (TAF). In this regard it is worth noticing that in order to improve the liquidity of the system most central banks also put in place non conventional interventions, with the specific objective of ensuring sufficient liquidity to the interbank market, and de facto substituting commercial banks in that market. Open market operations have been reinforced notably by expanding the range of assets required as collateral, and including assets whose value was difficult to determine in the market (thus transferring some of the bad loans into the balance sheets of the central

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[2] It has to be emphasized that this mandate of the ECB is written in European treaties which are more binding than a constitution as they can be modified only by unanimity. The Government of Europe is constrained by rules and is prevented from discretion; see e.g. Fitoussi, (2002), Fitoussi and Saraceno, (2004).

[3] There are pros and cons to this distinction: it is obviously not relevant for developing countries where energy and food represent a high proportion of household expenditures; it may also loose its relevance in developed countries where inequalities and poverty alike are increasing.

banks). Furthermore, central banks have increased their exposure, by engaging in longer term loans to the banking sector. Hence one of the common features to central banks reaction has been to hugely increase their quasi-fiscal operations without entering into formal agreement with the treasuries.

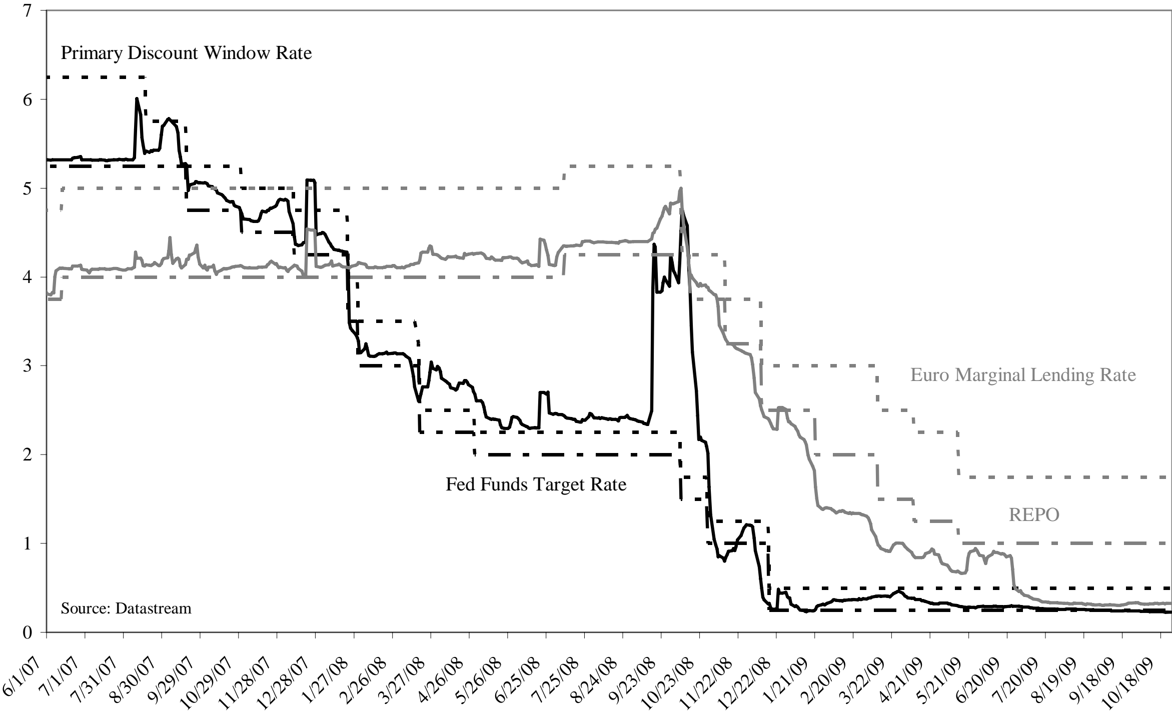

Figure 3 - Target rates and interbank short (1 week) rate. US-EMU

Figure 3 also reports the 1 week Libor and Euribor. It emerges quite clearly that while very different in the initial phase, both strategies succeeded in bringing down to acceptable levels the spread between short term rates in the interbank market and the target rates. It may actually be said that the ECB was more successful in stabilizing short rates, even if this is explained to a good extent by the different severity of the crisis in the two zones. But here we have clearly an assignment problem: how much of this relative success was due to the action of fiscal authority (bailing out of the banking sector, deposit guaranty, recapitalisation etc.) and how much to the action of the central banks? (That highlights the remarks made above about the Tinbergen-Mundell rule).

We can further assess the relative tightness of monetary policy in the two zones by comparing short term rates with the rates that would be consistent with a Taylor rule taking into account inflation and the output gap. Figure 4 shows that the ECB rates were consistently above the level that would have been implied by the Taylor rule, whereas in the US they were more variable[4]. In particular rate cuts were more aggressive both during the crisis of 2001, and the current global recession, while policy turned restrictive during recovery phases.

[4] We assumed a potential growth rate of 2.5% in the EMU, and of 3% in the US, which are also the target real interest rates. The inflation target is assumed to be 2% and 2.5% respectively.

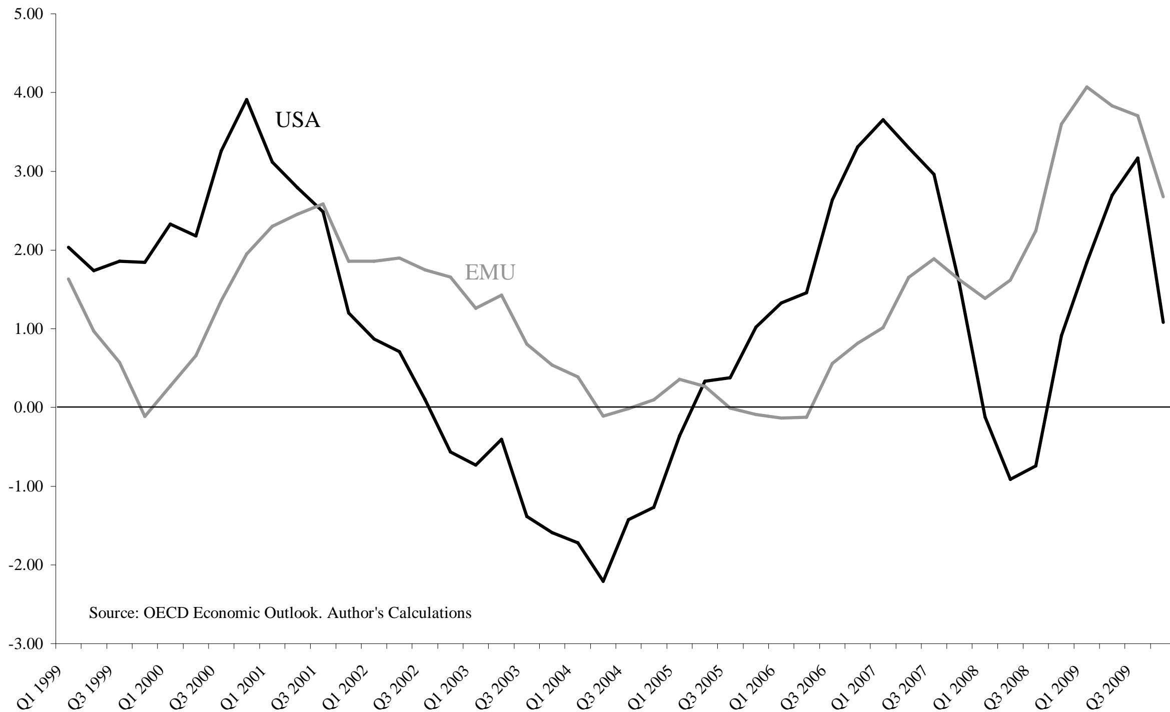

Figure 4 - Spread between short term rates and the Taylor Rule

To summarize, monetary policy has been correctly praised as having been effective and timely in preventing a meltdown of the banking sector, even if it remained more restrictive in Europe than in the US. Nevertheless, as successful as it has been in avoiding a catastrophic event, monetary policy has not been able to restore confidence. The massive injections of liquidity into the system have been hoarded (or invested in safe public bonds) by banks in an attempt to restore more reasonable prudential ratios. The liquidity trap re-emerged from economic history books, and by the end of 2008 it was well installed in our economies. Monetary policy has run out of steam, at least as the main tool of macroeconomic policy intervention. As in a standard textbook case, from the spring 2009 fiscal policy has taken the leading role to sustain aggregate demand.

Fiscal Policy

In a situation of liquidity trap private savings massively go into government securities, in a "flight to safety". The government has to transform these savings in demand in order to curtail deflationary expectations, to restore the value of assets, and ultimately to escape the deflationary process. Three main principles and elements of an effective stimulus package should be highlighted:

1) A large part of it should take the form of public investment, to build and modernize infrastructures, to avoid rent seeking, pork in the barrel projects, and to lay the foundations for future growth.
2) The current crisis is leaving on the ground many casualties, like home owners, blue collar workers, and entire sectors. An important part of the planned expenditure should be targeted at relieving their conditions and to sustain their income and capacity to spend.
3) As could be expected, even as GDP growth resumes unemployment is increasing significantly in most countries, both in the existing workforce and among those who will enter in the workforce in the next months. Everything should be done to avoid them to become discouraged, and to provide them with safety nets.

As for the size, estimates converged on the need of a fiscal stimulus of around 2% of GDP, if no country plays a free rider game. In fact, standard textbook analysis shows that the size of the multiplier is significantly increased by a joint (if not coordinated) effort. There is nevertheless a real difficulty in measuring the amplitude of the crisis, and the effects of macroeconomic policies aimed at dampening it. This difficulty is reflected by the continued revisions of policies and forecasts by national governments, even before the plans are put in place. This makes it rather difficult to give a quantitative assessment of the needed stimulus. While of course it depends on the fact that the crisis is still unfolding, this uncertainty is at least in part an unavoidable consequence of the dismissal of tools that allowed in the past to evaluate policy in the global economy, notably multi country models. Today only a few institutions have multi country models and use them for policy analysis and forecasting. Their dismissal in the past, because Keynesian and hence "out of fashion", was a mistake that we are paying today. This difficulty is compounded by the fact that due to structural changes in the world economy since decades, the statistical indicators on which we rely (mainly GDP) are flawed with a series of measurement problems (Stiglitz, Sen and Fitoussi, (2009))

It is worth noting that some countries, notably developing ones, may not be in the position to afford a fiscal stimulus of several points of GDP. It is of foremost importance that the international community helps these countries to carry out the needed measures exactly as it needs to help them with the banking rescue packages. OECD countries should resist the temptation to cut foreign aid spending; ideally, foreign aid should be increased. But until now, the news from this front are rather disappointing as it appears that foreign aid has effectively decreased.

Finally, a word should be said on sustainability. Most countries have already implemented stimulus packages and will most probably continue to do so in the near future. Thus, it is normal to observe concerns about the long term sustainability of current action that emerge in the speeches of the heads of state and government around the world. While the issue is important, we should bear in mind that in this case we are talking about a countercyclical policy, and that no long term sustainability concern should appear, as long as policy will remain countercyclical. This means that as the economy will enter in an expansion phase, fiscal policy should turn restrictive. It is very important that this does not happen too late, but it is even more important that it does not happen to early. Turning to budgetary restrictions before the crisis is over, could undermine all the previous effort to sustain growth. This is why the talk about an exit strategy mentioned in the introduction looks extremely worrisome. Also, the importance of composition of spending as regards sustainability should be underlined; public investment, if it succeeds in increasing the growth potential of the economy and hence future growth, may pose less sustainability problems.

Table 1 details the stimulus plans adopted by EU countries and by the major economies of the world, With a stimulus package of 5.6% of GDP spread over three years (2008 to 2010), the United States have adopted an aggressive fiscal policy stance to face the crisis. Fiscal stimulus in the EU 27 is 1.4% of GDP over the same period, four times less than in the US. The euro area, which totals 73% of GDP in the EU 27, contributes in about the same percentage to the global stimulus in 2009, but nearly 90% in 2010. In fact, non EMU European countries seem to be constrained by threats to the stability of their currency. This is the case of Hungary but also to a lesser extent the United Kingdom, whose stimulus is the size of the European average, but concentrated only in 2009.

Table 1 Stimulus Plans

	% of GDP	Effect				% of GDP	Effect		
		2008	*2009*	*2010*			*2008*	*2009*	*2010*
Austria	1.1	0	0.9	0.2	Czech Republic	3	0	2	1
Belgium	1.6	0	1	0.6	Denmark	2.5	0	0.8	1.7
Finland	3.1	0	1.5	1.6	Hungary	-4.4	-0.7	-1.9	-1.8
France	0.6	0	0.5	0.2	Poland	1	0	0.8	0.2
Germany	3	0	1.4	1.6	Sweden	2.8	0	1.5	1.3
Ireland	-4.4	-0.7	-1.9	-1.8	UK	1.4	0.2	1.3	-0.1
Italy	0	0	0	0	**UE 27**	**1.4**	**0.1**	**0.8**	**0.5**
Netherlands	1.5	0	0.8	0.7					
Portugal	0.8	0	0.8	0	**USA**	5.6	1	2.1	2.4
Spain	3.5	1.1	1.6	0.8	**Japan**	2	0	1.5	0.5
Euro Zone	**1.6**	**0.2**	**0.8**	**0.6**					

Source: OECD - National Accounts - OFCE Forecasts, Spring 2009

Within the Eurozone, Germany, Spain, and Finland have recovery plans of around 3 percentage points of GDP. In contrast, France, Italy and Portugal appear inertial, while Ireland contributes negatively to the European stimulus by adopting a strongly pro-cyclical policy.

Since January 2009 no major element came to alter the picture, with the exceptions of a plan for tax cuts by the newly elected German government, which should account for about 1% of GDP (24 bn euro), and a plan of the French government to cut taxes to the business sector that is forecasted to cost around 0.4% of GDP (11.7 bn euros). Moreover the French Government is preparing an investment program devised to the long run and financed by borrowing ("le grand emprunt"), of around 35 billions euro spread on several years.

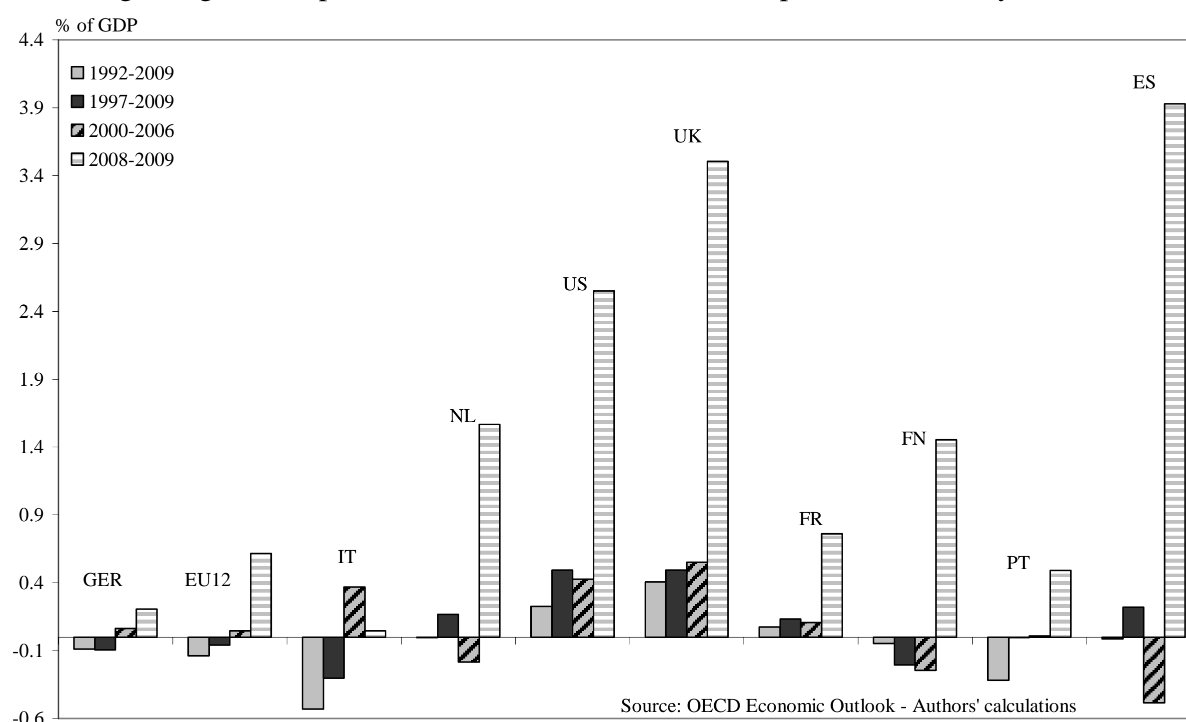

Figure 5 - Average yearly fiscal impulse

To summarize, the answer of EU governments to the crisis is significantly less aggressive than in the US and even in Japan, both on impact and over time. While this can be justified for smaller non eurozone countries, which face the risk of a currency crisis, it is much harder to find a rationale for the timidity of large eurozone countries. If we read these facts together with the comparatively less expansionary stance of the ECB with respect to the Fed, we conclude that macroeconomic policy has been far more inertial in the EU than in the United States.

The reaction to the current crisis, furthermore, constitutes no exception, as in the past two decades macroeconomic policy in Europe has played a distinctive minor role. We saw in Figure 4 how monetary policy has been less reactive than in the US. Similarly, discretionary fiscal policy in the past decade has not been as responsive to the cycle as it should have been.

The fiscal requirements of the Maastricht criteria and of the SGP had a deep influence on the pattern of public finances in European countries. Figure 5 shows the fiscal impulse for a number of countries, computed as the negative of year on year changes in cyclically adjusted government net lending, and averaged over different periods. Such an indicator measures the discretionary fiscal stance of the country, a positive number being an expansionary stance. All the eurozone zone countries included in the figure, be them large or small, virtuous (Finland) or less so (France, Italy, Germany, The Netherlands, Portugal), had an overall restrictive stance since the early 1990s. The pattern is particularly striking if we take the subperiod 2000-2006: in spite of sluggish growth, the orientation of fiscal policy did not change, and remained restrictive. This contrasts with the United States and with the United Kingdom, where fiscal policy was more reactive to economic conditions. Figure 6 shows the scatter plot of changes in the output gap against the fiscal impulse for the US and the Euro zone In the US fiscal policy has been countercyclical (expansionary in 2001-05, and of course in 2008-09, contractionary during the expansion of the 1990s and in 2006-07). This pattern shows that fiscal policy has constantly been in the policy maker toolbox, regardless of the administration (the sample spans the Clinton and Bush terms). In the Euro zone, the consistently restrictive fiscal stance happened to be countercyclical in the second half of the 1990s. It was slightly countercyclical during the difficult years at the beginning of this decade, and overall rather mild even in the current recession. If we look at the details of the correlation between fiscal impulse and output gap we observe that all the large eurozone countries, with the exception of Spain had a mildly procyclical stance. Only Finland has a reactivity of fiscal policy comparable to the one of the US and of the UK.

The heterogeneity of the countries considered leads to link this restrictive stance to the efforts for entry in the EMU in the 1990s, and for trying to respect the SGP constraints since 1997.

We argued elsewhere at length (Fitoussi and Saraceno, (2004; 2008)) that the inertia of macroeconomic policy has to be traced back at the institutions for the economic governance of Europe, notably the statute of the ECB, exclusively focused on inflation, and the Stability and Growth Pact that limits discretionary fiscal policy. As we said above, these institutions are not meant to consider the tradeoffs facing policy choices, and target nominal stability rather than growth.

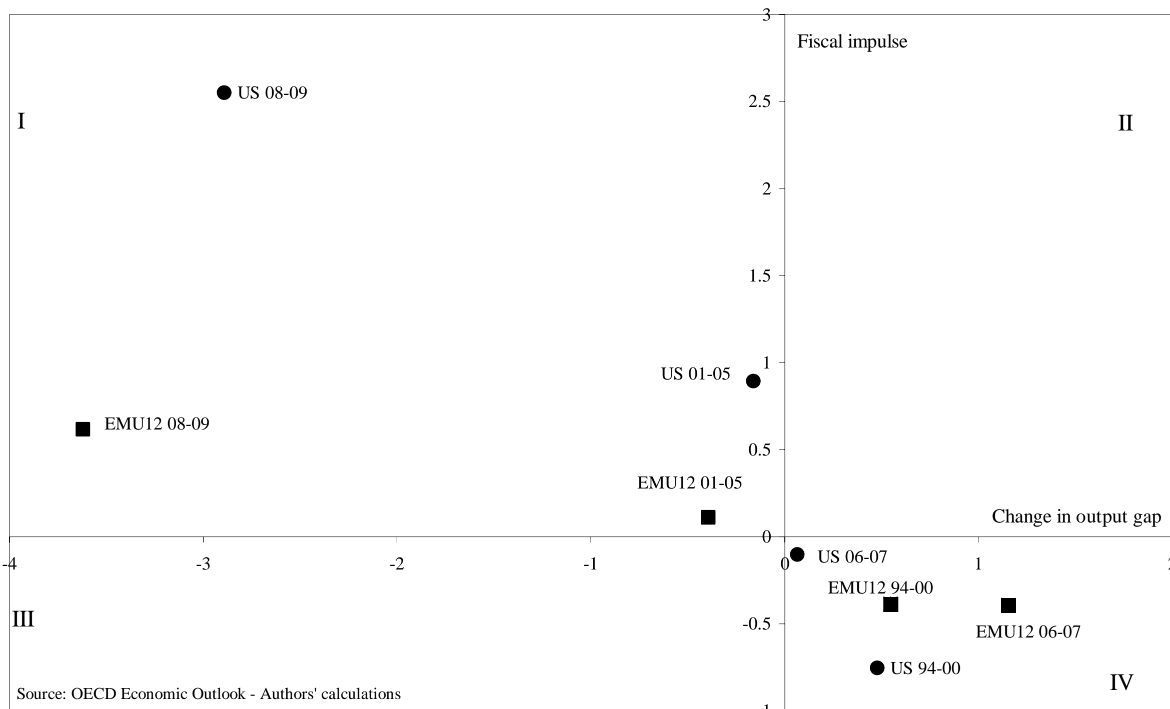

Figure 6 - Change in output gap vs fiscal impulse

4. What Helped France Smooth the Impact of the Crisis?

Within the European countries France seems to have been able to cushion the crisis better than its partners. We saw in figure xx that according to our forecasts the growth performance of France in 2009 is probably going to be similar to the one of the US, and significantly better than the eurozone countries, a forecast that is confirmed by the latest (October 2009) IMF economic outlook. France looks more resilient than its large eurozone partners also if we look at industrial production. What explain the better resilience of France with respect to other large Eurozone countries? Two factors may actually explain this.

The first is the relative strength of automatic stabilization in France. Creel and Saraceno, (2009) show that in France the trend towards lowering the strength of automatic stabilizers has been less marked than in other countries, while the weight of the government on the economy remains larger (see also Fatas and Mihov, (2001)). This has more than compensated the timidity of the discretionary stimulus, thus providing an overall support to aggregate demand larger than in Germany or in Italy.

The second element that could explain a relatively better performance of the French economy is more structural. We discussed above how increasing income inequality (widely documented: for a recent assessment of the US, look at Heathcote, Perri and Violante, (2009)) in the past three decades has weakened aggregate demand and increased aggregate savings in most countries. If we look at the most recent international comparisons, nevertheless (IMF, (2007), OECD, (2008)), we observe that according to most measures the trend of mounting inequality has been less pronounced in France than in other countries. Thus, this structural weakening of aggregate demand was less important. This effect may be felt especially during a recession, because low-income classes have a better capacity to sustain their consumption. The “French model”, as branded recently by *The Economist* (*The Economist*, (2009)), would then have been more resilient both because of the public (automatic stabilization) and the private performance.

5. Lessons for Developing Countries

The current crisis originated at the hearth of the globalized world economy -- the United States --, but is likely to have more lasting effects on developing countries, many of which did behave properly from a macroeconomic policy standpoint, and in what concerns the behavior of the financial sector. These countries suffered from the drying of financial markets, and from the generalized drop of confidence of foreign investors, as well as from a steep reduction of demand for their exports. But also, indirectly, because the crisis contributed to the decreasing trend of food and energy prices, of which many of them are exporters. Finally, there are also increasing risks of being negatively impacted by more or less explicit protectionist policies that are currently surfacing in developed countries.

All these factors concur to the severe disruption of the economy of low income countries. The private sector in these countries is often unable to cushion the shocks, with long lasting effects on malnutrition, school attendance etc, that are exacerbated by the absence or the insufficiency of well functioning welfare systems. In addition, developing countries' governments lack the financial means to carry on the measures required to face the crisis. Two high-level expert documents (Stiglitz et al., (2009), Fitoussi and Stiglitz, (2009)) have recently discussed how resources should be made available to low income countries, and for what use. The main conclusions are that infrastructure investment, social spending in the areas of nutrition, basic education and health should be the focus of fiscal policies in developing countries, especially at a moment in which these expenditures tend to be reduced (Ilzetzki and Vegh, (2008)). This is why help from developing countries and international financial institutions should be provided. Furthermore, as we mentioned above, increasing resources devoted to rescue packages should absolutely not be done through a reduction of ordinary aid funds, that should on the contrary increased as much as possible.

The second lesson that the crisis allows to draw for developing countries is that policies should be implemented to reverse the trend in distribution, and hence to contribute to sustain aggregate demand in the medium-to-long run. These may include: (a) measures aimed at increasing the progressiveness of the tax system, in particular for high and very high incomes; (b) a general redesign of the welfare system, aimed at redistribution and human capital formation. This would imply in particular the generalization of universal health care and education provision. These measures would also help to reintroduce (or to introduce *ex-novo*) a more important role for automatic stabilizers, and would more generally enhance the insurance role for the government that is necessary to cushion the business cycles especially for low income and liquidity constrained consumers and investors.

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