# The Continuing Crisis:

# Causes, Policy Responses and the Need for Structural Reforms

**By W R White**

**Chair, Economic and Development Review Committee**

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**Brdo pri Kranju**

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## Introduction

It is a pleasure to be with you here today. Let me begin by saying that my comments in this Keynote Session are entirely my own and in no way should be attributed to the OECD.

Before turning in the later sessions to the heart of today's discussions, the OECD review of Slovenia, let me spend a few minutes on the broader global context. This is relevant for two reasons. First, what goes on elsewhere in the world, but particularly in Europe, will have a strong influence on what happens in Slovenia. Second, it is important to note that many of the difficult policy issues faced by Slovenia are not in fact unique to this country. Many other countries are facing very similar problems and are also being confronted with the need to take some very difficult policy decisions.

The core of what I wish to say today is that standard macroeconomic policies of demand stimulus have been overused in many countries, not least in the course of the crisis itself. As well, many of the measures taken to date to shore up financial systems and preserve jobs in traditional industries are beginning to reveal their downsides. Against this background, structural reforms to improve the supply side of our economies are moving to centre stage. Such structural policies are politically difficult to implement and may take time to show results. Nevertheless, absent any feasible alternatives, they must become the core of policies to restore growth that is balanced and thus sustainable.

Unlike most economies, which historically have suffered many violent crises, my presentation will be highly linear. Let me begin with the "continuing" aspect of the crisis. Why do I think the global economy is not out of the woods yet? Then let me go on to the "causes" of the crisis. Here we will see how the boom preceding the crisis both made the bust inevitable and led to the headwinds (using Chairman Greenspan's terminology) that have made the recovery so fragile. Then let me say a few words about the policies used in response to the crisis and their limitations. Finally let me explain why all of this leads to the conclusion that structural reforms must be at the heart of the policy agenda. And, I repeat, not just here in Slovenia but almost everywhere.

## Not out of the woods yet?

When we look at the global economy today, it suffers from most of the same fault lines that were evident when the crisis hit in 2007. Indeed, some of the developments since then have arguably made things worse not better. In short our starting point does not warrant total confidence that all will be well as we go forward. Both the OECD and the IMF think the best forecast still remains that of a steady if moderate global expansion. However, this should not blind us to the possibility of downside risks for which we should try to prepare.

One problem is the prospect for global "inflation". We now have a bipolar world in which the emerging market economies (EME's), particularly in Asia and Latin America, are clearly pushing up against the limits of their potential. At the same time, many of the advanced market economies (AME's) seem well within their production potential as evidenced by continuing high rates of unemployment. As a result, many EME's are beginning to worry about inflation. Indeed, in spite of the continuing high unemployment in a number of AME's, inflation is on their radar screen as well. Higher import prices from EME's, higher global commodity prices, lower currency values and crisis-related declines in the level of potential in AME's have all contributed to this risk. Moreover, negative supply shocks for food have been distinctly unhelpful everywhere.

Another problem is that of remaining "domestic imbalances" within many countries. Many asset prices continue to seem very high relative to fundamentals; house prices are rising fast in many EME's, and continue to approach record levels in virtually all AME's with well functioning banking systems. In other AME's (like the US, UK and some Euro area countries) where uncertainties remain about the health of the financial system, the problem is that credit flows have not yet returned to normal. Spending patterns also continue to be abnormal. Household saving rates in virtually all the English speaking countries remain well below historical averages. In contrast fixed investment in China is now over 50 percent of GDP. Evidently in both cases, there must be a serious risk of mean reversion and a slowdown in demand.

And a final set of problems revolves around "external imbalances". The US trade deficit has fallen for cyclical reasons, but the underlying trend is still not sustainable. In contrast, large creditor countries continue to accumulate foreign exchange reserves which have now reached unprecedented levels. These developments continue to spark concerns of a dollar crisis and/or recourse to protectionist measures. Moreover, with unemployment still high in AME's, and exchange rates appreciating in EME's, central banks everywhere are hesitant to tighten monetary policy. This response can only worsen the inflationary dangers I just referred to.

As you are all too well aware, a similar set of dangers are evident within the Euro area. Germany is powering ahead, in large part due to buoyant exports, while a number of peripheral countries suffer from the dual problem of being internationally non-competitive and having high debt levels (either private or public or both). The dilemma here is that restoring competitiveness could imply falling prices which would aggravate the problem of debt service. Absent the opportunity to devalue, this dilemma can only be resolved by supply side reforms and faster growth to make the burden of debt more sustainable. Evidently, should inflationary pressures in the Euro area as a whole lead to the need for higher policy rates, the dilemma for the peripheral countries would be intensified, and the need for structural reforms all the greater.

## The causes of the crisis

The crisis began in the subprime mortgage sector of the US economy and quickly spread around the world with devastating effects on both the financial system and the real economy. There are two schools of thought about what caused the crisis. One I have described as the "comforting school of what is different" and the other the "less comforting school of what is the same".

The former essentially says the crisis had its roots in the financial system. In particular, there were many innovations (like the use of off balance sheet vehicles, structured instruments, the originate-to-distribute model, etc.) which had adverse and unforeseen side effects. Indeed, this school of thought is comforting because it would go even further and say these side effects were essentially unforeseeable. Evidently, there is a degree of truth to this, but only a degree.

The latter school essentially says the crisis had its roots, not in the financial system, but in the fiat monetary system which allows credit to be created in excess of people's willingness to save. This school draws its inspiration both from economic history and the history of economic thought. As for history, adherents would note that we have had repeated crises of the current sort from time immemorial. Each of them was unexpected, and most of the really big ones (eg the Great Depression) were not preceded by any significant amount of inflation. Virtually all of them, however, were preceded by sharp increases in the rate of growth of credit. As for the history of economic thought, there were many pre War thinkers, among them the so called Austrian school, who had articulated theories about why these crises are so recurrent and generally look so similar.

In a nutshell, these pre War thinkers pointed to a cycle of boom and bust that began with some good news and justified optimism. This led to banks extending more credit which helped buoy both the real economy and financial markets. Rapid growth, and the collateral provided by rising asset prices, led to still more credit, but also declining lending standards and spending on bad (unprofitable) investments or consumption. Either would threaten the capacity of the borrower to repay, and in turn the solvency of the lenders themselves. The boom would turn to bust either when inflation started to rise, or when the "imbalances" in the economy (mostly associated with unsustainable debt levels) began to weigh on further spending. In effect, it was a horse race between an inflationary and a deflationary outcome, with the winner being revealed only after the event. In both cases, however, the imbalances would weigh heavily and durably on the economy, particularly if the financial system had been seriously compromised.

This school of thought is less comforting, because it says that all the warning signs were there prior to 2007 and the authorities simply missed it. Asset prices had exploded, bank lending standards were falling relentlessly, and credit spreads had fallen to record lows. Debt levels and leverage everywhere had never been higher. Worse, the central banks in the AME's had already aggravated the underlying problem of imbalances by easing monetary policy in successive cycles (at least as far back as 1987) whenever there was the slightest risk of a downturn. Debt levels thus built up cumulatively. Moreover, although only more recently, the EME's made it a truly global bubble through the actions they took to prevent their exchange rates from rising in the face of low policy rates in the AME's.

Why did the authorities miss it? The underlying problem was that they were using analytical frameworks that had no room for credit, or imbalances, or for booms and busts having potential effects on both the financial sector and the real economy. Central banks were focussed on inflation alone, while inflation was being held down by the return to the global market system of previously socialist countries. As a result, central banks felt no need to raise rates sharply in upturns and no impediment to lowering them sharply in downturns. This asymmetric response was also encouraged by the Fed's doctrine of "Clean Don't Lean". The consequence of this asymmetry was that, even as imbalances grew ever larger, policy rates were also ratcheting down towards zero. As a result of this process, risks were allowed to increase even as the capacity to deal with the risks was decreasing.

Which school of thought you belong to has many important implications for policy. As a matter of logic, causes of problems must be identified before solutions can be recommended. These implications extend to crisis management, crisis prevention and the institutional frameworks to best manage both.

The school of what is different focuses on problems arising in the financial sector. Thus, blame for the severity of the crisis primarily belongs to bankers and regulators of the financial sector. Getting out of the crisis is a matter of standard Keynesian stimulus accompanied by measures to ensure the proper functioning of the financial system. Looking forward, measures to ensure financial stability will prevent future such crises from happening. Institutionally, separate agencies to ensure price stability and financial stability respectively would seem perfectly acceptable.

The school of what is the same focuses primarily on balance sheet issues, not only within the financial sector, but also elsewhere because the crisis is seen as having deeper monetary roots. Thus, the circle of blame would have to be extended to include central bankers. Getting out of the crisis, without sowing the seeds of the next crisis, depends on more than just demand side stimulus. Looking forward, both monetary and regulatory policies will have to be used to prevent further crises. Institutionally, there should then be one agency (likely the central bank) to ensure coordination of the various instruments available to policymakers as they try to lean against the credit cycle.

## The policy response to the crisis and its limitations

Since the middle of 2007, the policy response to support the financial and real sectors has been unprecedented in its scope, imagination and duration. There can be little doubt that it saved us from a downturn that might have been worse than the Great Depression. Yet virtually every action taken, however effective in the short run, has had medium term downsides that are becoming increasingly evident. It is this insight that accounts for many commentators suggesting that we should not rely on similar policies going forward.

I have already touched on the downside of very easy monetary policies. With policy rates at zero, longer term rates can be affected only by promises to keep rates low (which may not be credible) or by direct purchases of such instruments (which may not be effective). As for quantitative easing, many central banks (including the European Central Bank and the Bank of Japan) would dispute its effectiveness in raising real demand while also noting its potential to stoke inflationary expectations. Many feel that a combination of these policies in AME's, and a "fear of floating" in EME's, has led directly to inflation and bubbles in these latter countries. Finally, there is the concern that very low interest rates allow the survival of "zombie" companies financed by "zombie" banks. These near dead hold back the living with the result that productivity and secular growth decline. Japan is a good example of a country that never made the structural reforms required by its crisis. Now, decades later, it is still suffering from this shortfall.

Fiscal stimulus also has its downsides. In effect, it serves to transfer debt from the private sector to the public sector, but does not make it disappear. While the government might in principle have a greater capacity to service such debt, in practice this is no longer the case for many countries. There has been a consistent tendency for decades to allow deficits to widen to cushion downturns, but also to resist building up fiscal surpluses in upswings. Similar to monetary policy, there has thus been a policy asymmetry which has seen government debt levels ratchet up continuously over many cycles. Countries facing bad demographics, which includes most European countries and Japan, have a further “off balance sheet” problem that needs to be taken into account when assessing the desirability of yet more stimulus.

The practical implication of high debt levels is that, at a certain point, the markets take fright and bond levels begin to rise. We have already seen this in a number of the peripheral countries in Europe, so it is not a hypothetical problem. Further, there is some evidence that, when sovereign debt relative to GDP hits a certain level, then growth potential also begins to decline; a double whammy. Finally, if a country has its own currency, a lack of market confidence could lead to a costly currency crisis. Many fear such an outcome in the United States, if political wrangling in Congress implies no progress in putting their debt on a sustainable path. Evidently, with over ten trillion dollars of gross exposure to assets denominated in US dollars, foreigners would suffer along with US residents. Depreciation is, for them, simply a silent form of default.

Similarly, the massive support provided by governments to the financial system also has many worrisome side effects. In addition to the observation above, that the good health of the financial system is by no means yet assured, their might well be concern for “moral hazard”. Earlier dangerous practices, like momentum trading and the excessive pay out of bonuses, have not been modified. The previous “too big to fail” problem has clearly been made worse through both mergers and acquisitions and growing concentration in certain markets. Finally, it is worth noting that the policy changes intended to make the system safer in the future (in particular Basel 3) also have their shortcomings. Not least, the issue of systemic risk has not yet been seriously addressed. This implies that the negative features of the support packages to date could have implications far greater than is currently thought.

For completeness, it is also worth noting some of the shortcomings of the policies introduced over the last few years to support certain industries and specific jobs. Programmes such as “cars for clunkers” steal demand from the future rather than creating wholly new demand. Further, it seems incongruous to support an industry suffering from chronic excess supply.

Other programmes, like government subsidies to support short time working in many European countries and in Japan, also seem likely to be counterproductive over time. It is a fact that most of these programmes were used to support jobs in the manufacturing sector in countries with large trade surpluses (eg: Japan, Germany, Switzerland and the Netherlands among others). If these surpluses are in fact unsustainable, then so too are the specific jobs behind them.

More broadly, production capacities in many industries in AME’s rose during the bubble period, in response to high demand. These industries (not least construction and banking) must now downsize. Government programmes that try to impede this will not succeed. By the same token, the reliance on “export led strategies” to drive growth in many EME’s must increasingly be questioned. If the importing countries are too indebted to buy, those engaged in export will have to turn to something else. Evidently, such a reorientation would have implications for structural reforms as well.

## The need for comprehensive structural reforms

The thrust of the above comments is that the prospects for growth in the AME’s, particularly those that are heavily indebted, will be modest for some time. Moreover, it has also been argued that the room for further monetary and fiscal stimulus in such countries is very limited. As for EME’s, an increasing number of them are facing inflationary pressures or bubble like symptoms. Again, the scope for traditional macroeconomic stimulus would seem limited. To restore robust growth in the former set of countries, and to reduce inflationary pressures in the latter, structural reforms will be required. Structural reforms will also be crucial in dealing with both global trade imbalances and similar imbalances within the euro area.

These arguments can also be put in a slightly different way. The crisis is estimated to have reduced the level of potential output by an average of 3 percent in OECD countries. To avoid actual reductions in living standards in AME's, structural reforms to enhance growth prospects will be required. Everywhere, but especially in EME's, constraints imposed by government regulation seriously impede sustainable growth. In short, there are plenty of "low hanging fruit" if the political will can be found to pick them.

There is no time to run through all the structural reforms suggested in OECD publications like "Going for Growth". While they clearly vary across countries, reforms that would increase the stock of capital and the supply of labour would come close to the top of the list in most cases. This is certainly true in Slovenia, notwithstanding its high level of GDP per capita relative to other transition countries.

Concerning the stock of capital, a business friendly environment and a receptiveness to the many advantages of foreign direct investment would seem particularly important. As for labour markets, many countries have very tight employment protection legislation which leads to an unwillingness to hire labour in the first place. Very high minimum wages also have similar effects and hamper competitiveness. In Slovenia, a rigid labour market, a high level of the minimum wage relative to the median wage, and insufficient productivity in various sectors raise the risk of having only a subdued economic recovery. Finally, raising the effective retirement age constitutes something of a magic bullet. At one stroke it would likely increase demand, would also increase the supply of labour, and would improve the sustainability of pension systems and the government's finances. Given how life expectancy has been rising in most countries, the need for this particular structural reform would seem obvious.

Pension reform is a further pressing need in many OECD countries. This certainly is the case in Slovenia which faces one the highest future increases in public spending on pensions in the OECD. Not reforming the system now would both damage fiscal sustainability and increase the tax burden on next generations.

Two other sets of reforms should also be highlighted, because they deal directly with the “imbalances” problems I have emphasized above. The first has to do with restructuring the banking system, which is also needed in Slovenia. History teaches clearly that identifying problems of potential insolvency, and dealing with them quickly and decisively, is the least costly way of exiting from crisis. The alternative is weak financial institutions either “gambling for resurrection” or constraining the flow of credit for years. The second set of reforms has specifically to do with trade imbalances. Countries with big trade surpluses should encourage the production of non tradeables, in particular by deregulating the production of services. The scope for this in Germany, Japan, Korea and China is vast. By the same token, countries with large trade deficits should carefully explore what structural measures might improve their international trade competitiveness. Evidently, deficit countries without the capacity to devalue their exchange rate, like Slovenia, should take this challenge particularly seriously.

## A concluding observation

The political economy of structural reform is difficult. Vested interests are concentrated in a few hands that know how much they have to lose. They will resist change vigorously. In contrast, the many citizens that might gain have little understanding and mount no political pressure for structural reform. Structural reforms also take time, and in democracies the electorate is sadly prone to lose patience. In these circumstances, governments must first embrace what needs to be done in the longer interests of its citizens. They must then communicate that need clearly and repeatedly. And, finally, they must then get on with the reforms themselves and stick with them.

Admittedly, this is not an easy path politically, even for a country like Slovenia which has a long tradition of policies forged by social consensus. But, as I have tried to argue above, it also helps if structural reform is the only path leading from where you are to where you want to go.