February, 2011

Comments on Key Lessons from the Economic Crisis

Robert C. Shelburne, *United Nations Economic Commission for Europe*

International Labour Organization Conference on the Key Lessons from the Economic Crisis

Comments by Robert C. Shelburne
Chief Economist
United Nations Economic Commission for Europe
February 16, 2011

I want to cover three main topics in my time today.

- First, I will say just a few things about the state of the global economy and the nature of the recent financial crisis, and in so doing make a few comments about the first paper by Raymond Torres.
- Secondly, I want to briefly discuss the economic situation in the transition economies, since none of the other papers have discussed them, and they were in fact, the most negatively impacted region in the world.
- And thirdly, I will make a few comments on some specific points that were raised in the regional papers. (More specifically, Andres Marinakis on Latin American and Lawrence Egulu on Africa.)

The world economy is experiencing a two-speed recovery; the emerging/developing economies have recovered strongly from shallow economic downturns while the advanced economies have weak recoveries from very deep downturns. As a result in the developing world unemployment is close to pre-crisis levels, while in the advanced economies it remains extremely high and is likely to stay high for at least several more years. Of the 30 million thought to be unemployed today due to the crisis, three-fourths or 23 million are in the advanced economies. Many of these are already structurally unemployed due the required real changes these economies must undergo, and as time goes on even more will become so.

The fact that we have a two-speed recovery has some important implications. Because of their different economic circumstances, countries now differ substantially in what type of economic policies they are implementing, and what type of policies they think other countries should be implementing. As a result it is becoming much more difficult to achieve inter-governmental cooperation, and numerous policy conflicts have developed. Exchange rates are one such example.

As we know, the world experienced its worst financial shock in almost a century; we were saved from a depression by the extensive use of expansionary monetary and fiscal policy. Although a majority of professional economists accept this, it is disturbing that such a large percentage of the population and many public officials view the stimulus as the problem and not the solution. The failure to properly understand this has led to the pre-mature withdraw of stimulus in the advanced economies which has extended needlessly the extent of the crisis.

Unfortunately, this is a re-play of the same mistake that was made in the 1930s. The austerity that has been implemented over the last year was not imposed by economic conditions, but in most cases was a policy choice that was made. In my view, a very poor policy choice.

The evidence shows that labor market institutions and policies have been important in mitigating the crisis and can also explain some of the cross-country variation in the extent of the crisis. This is especially true regarding its labor market impact. Despite the importance of labor market policies, it must still be recognized that traditional macroeconomic monetary and fiscal policy must do the heavy lifting in resolving crises.

Some forms of stimulus are much more effective than others and unfortunately in many cases the less effective measures were implemented. For example, tax cuts for high income individuals produce far less stimulus than spending increases, so we have not gotten the maximum bang for each buck.

Now, I agree with Raymond (Torres) that improper regulation of the financial systems in the US and Europe was the immediate cause of the crisis, while increasing inequality and global imbalances were deeper underlying causes. However, I do disagree with him on one major point. I do not believe it is necessary to address the underlying causes of the crisis in order to fix the crisis. To use the disease analogy, Raymond assesses the situation like a patient that is sick because he has cancer, in order to cure the patient one must obviously eliminate the cancer.

However, I view the situation is more like a patient who has slipped on a loose rug and broken his leg. We do not have to fix the problem with rug in order to heal the patient. However, obviously the rug creates a vulnerability that needs to be addressed in time or else he is likely to slip again. So I agree we need to be implementing policies to strengthen financial market reform and reduce inequality and global imbalances. These are very important issues, but it is not essential to do these things in order to get out of the crisis.

Just one example, the new Basel III requirements will strengthen financial markets, but in the short run their implementation may actually further delay recovery instead of being essential for recovery. There are other cases, such as reducing global imbalances that could speed recovery, but nevertheless they are not essential for recovery.

The Transition Economies

Let me say something about the transition economies of the CIS and south-east Europe as well as the EU new member states. This was the most negatively impacted region in the world during the crisis. GDP fell in these economies by 5.5% in 2009; this represented a 13 percentage point drop from the 7% growth they were experiencing before the crisis.

This was remarkable in that residents in these economies, unlike Western Europe or the US, owned few of the sub-prime assets which were at the heart of the crisis. The reason the transition economies were so negatively impacted was due primarily to their dependence on foreign capital, although falling commodity prices and their intensive trade with Western Europe were also important.

The recovery throughout most of the region has been moderate but growth is expected to be below trend for the next several years. The recovery has been particularly anemic in south-east Europe. In the CIS growth is expected to be only about one-half of what it was before the crisis.

Given this large decline in GDP, the region experienced the highest unemployment rate of any of the main regions of the world. This rate peaked at nearly 10.5% in 2009, having increased by 1.7 percentage points from 2008. This was a slightly higher unemployment rate than that in the US or the EU. In 2010 unemployment fell back by about half of this increase to 9.6%. This is of course substantially different from the US and EU where unemployment has fallen very little.

This increase in unemployment was large and the levels reached were high, but given the very large declines in GDP, the increases in unemployment were quite moderate. For example the change in growth in Russia was three times greater than in the US (14.5 vs. 5) but the increase in unemployment was only half as much, so Russia's unemployment increase compared to its GDP decline was only one-sixth of that in the US. I'm not sure if we fully understand what happened but the use of short-time work, bonus payments and shifting unemployment on to immigrants explains some of this.

Youth unemployment in the transition economies was particularly impacted as it reached almost 21%.

The main lesson that this region can offer regarding the crisis concerns the vulnerability created by dependence on foreign capital. Although external capital can allow a country to invest and consume more than it could otherwise, history has shown repeatedly that even when it is prudently used it can subject a country to increased volatility and as a result may not ultimately increase economic growth.

The Regional Papers

Let me now make a few quick points about the papers and their regional recommendations. Firstly I do not have anything to say about the current economic situations in these regions. I think these papers describe them clearly and correctly. Generally they are experiencing rather strong recoveries from rather short and modest downturns; of three regions, the downturn in Latin America, especially Mexico, was slightly more severe. With the crisis over, these regions have largely returned to their longer-term developmental challenges on which they were focused prior to the crisis.

The basic reason for this generally favorable outcome is summarized quite well by Andres (Marinakis) in the Latin American paper: these were: sound pre-crisis macroeconomic fundamentals, sensible macroeconomic and microeconomic policy responses as the crisis developed, and the external nature of the crisis.

I would like to elaborate on this last point. This crisis was different from most crises that affect emerging markets in that its source was due to an external problem and did not entail any fundamental domestic adjustment. Global trade and capital flows simply dried up. These countries were obviously affected and those with better fundamentals were affected less but the problems were elsewhere. What this means is that these countries were not expected to and did not have to undergo any fundamental changes due to the crisis. All they needed to do was to bide time and try to minimize the effects until they could return to where they had been.

This is a completely different situation from most emerging market crises when the impacted economies generally have to undergo some large structural change. This could include the need to reduce the economy's real wage, re-capitalize their financial sectors, or shift employment sectorally. The latter may be needed to shift employment from the non-traded sectors to traded sectors, to reduce the size of a specific sector such as the real estate or construction industry, the financial sector, or government employment. Note that the advanced economies are having to undergo these adjustments and that is why they were so impacted and their recoveries have been so slow.

Thus the reason the crisis had a moderate impact on the emerging economies was that the fundamental long-run shock which they experienced was quite small; although the initial shock was large it was temporary. This is not to deny the importance of their sound pre-crisis fundamentals, of their automatic stabilizers and of their wise implementation of discretionary macroeconomic policies.

Appreciation of the fact that this crisis was different, suggests that the future crises that they will experience will be fundamentally different. As a result I am a little skeptical about the policy recommendation raised several times by Andres that a number of the successful policies used during this crisis should be mainstreamed so they would be implemented swiftly and automatically in the next crisis.

Given the time, I can't go into detail but just point out a few things. Share-work programs may be great way to maintain employment until demand returns, but if structural changes are needed, keeping people in the wrong sector may be counter-productive. It would certainly not make sense for Spanish construction companies to be using share-work programs. Raising the minimum wage may help maintain aggregate demand when it has temporarily fallen but what if the crisis requires real wage declines as was the case in the Baltics? Additional fiscal spending may also help maintain employment but what if fiscal or debt problems are the key problem creating the crisis, as they are now in Europe's periphery?

Many of the policies that were successful this time are likely to be counter-productive in the future if they suffer a more traditional crisis.

Let me raise a several points from the African paper. The macroeconomic crisis in Africa is largely over, Africa is back to addressing the longer-term development issues it had before the crisis, these include addressing poverty, chronic un- and underemployment, hunger, and diversification. Lawrence (Egulu) lists the 5 pillars of the new African growth model. These are all generally good solid objectives but what specific policies are going to bring them about. This is not discussed but the devil is always in the details.

Let me take a slight issue with one of the pillars. This is the last one dealing with building a development state. There is certainly a need for a strong government to provide basic public goods like education, a proper legal and regulatory environment, and public infrastructure.

But it was unclear exactly what was meant by his call for a more activist role for the state and a resurgence of development planning. If these are code words for industrial policy then I would disagree. I would be the first to admit that in some cases industrial policy has proven to be quite successful but in many other cases it was a disaster. A clear prerequisite for having a successful industrial policy is quality governmental institutions. Most of the African economies do not have this and as a result it would be a mistake at this point to implement such a policy.

So in conclusion, I have raised a number of technical points or minor qualifications but overall I thought the papers were quite good at addressing the basic issues.