PA974-001
Policy Responses to the Great Recession
Lecture 26 (12/10/09)

Instructor: Menzie Chinn
Fall 2009
Implications

- Slower potential output growth
- Lower capital intensity
- Higher NAIRU
- Debt spiral or fiscal consolidation?
\[ Y = F(N, K, A) = Af(N, K) \]

\[ \frac{\Delta Y}{Y} = \frac{\Delta A}{A} + 0.7 \left[ \frac{\Delta N}{N} \right] + 0.3 \left[ \frac{\Delta K}{K} \right] \]

**Recent Revisions to Potential Output by National Authorities**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Growth Revisions (percentage points)</th>
<th>Components affected</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
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<tr>
<td>Congressional Budget Office (2009)</td>
<td>2007: -0.1 2008: -0.4 2009: -0.2</td>
<td>Capital: x</td>
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<tr>
<td></td>
<td></td>
<td>Labour: x</td>
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<td></td>
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<td>TFP: x</td>
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<tr>
<td>Euro Area</td>
<td>-0.4 2007 2008 2009 2010 2011: -0.2</td>
<td>Capital: x</td>
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<tr>
<td>Germany</td>
<td>-0.5 2009 2010 2011: 0.0</td>
<td>Capital: x</td>
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<tr>
<td>Deutsche Bundesbank (2009)</td>
<td></td>
<td>Labour: x</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.5 2007 2008 2009 2011: -0.5</td>
<td>Capital: x</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Phased in 5% reduction level of potential output over 2007Q3-2010Q3</td>
<td>Capital: x</td>
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<tr>
<td>HM Treasury (2009)</td>
<td></td>
<td>Labour: x</td>
</tr>
<tr>
<td>Italy</td>
<td>-0.4 2007 2008 2009 2010 2011: -0.9</td>
<td>Capital: x</td>
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<tr>
<td>Italian Treasury (2009)</td>
<td></td>
<td>Labour: x</td>
</tr>
<tr>
<td>Canada</td>
<td>-1.2 2007 2008 2009 2010 2011: -0.6</td>
<td>Capital: x</td>
</tr>
</tbody>
</table>


Figure 4.1. Growth in capital services, 2000-10
Quarter-on-quarter growth, annualised rate

1. Weighted average of Germany, France, Italy and the United Kingdom.
Source: OECD Economic Outlook 85 database.
Figure 4.2. **European unemployment ratchets up following severe recessions**

(a) Major European countries

- Correlation coeff. = -0.72
Figure 4.3. Changes in the incidence of long-term unemployment and aggregate unemployment, 2000-07

Source: OECD Economic Outlook 85 database; OECD calculations.
Table 4.2. Growth in total economy potential output and its components  
Annual averages, percentage points

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<tr>
<td>Australia</td>
<td>-5.8</td>
<td>3.6</td>
<td>2.8</td>
<td>2.4</td>
<td></td>
<td>1.3</td>
<td>1.0</td>
<td>1.3</td>
<td></td>
<td>2.3</td>
<td>1.8</td>
<td>1.0</td>
<td></td>
<td>0.4</td>
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<tr>
<td>United Kingdom</td>
<td>-6.4</td>
<td>2.2</td>
<td>1.3</td>
<td>1.7</td>
<td></td>
<td>1.4</td>
<td>1.3</td>
<td>1.6</td>
<td></td>
<td>0.8</td>
<td>0.0</td>
<td>0.1</td>
<td></td>
<td>1.8</td>
</tr>
<tr>
<td>United States</td>
<td>-5.4</td>
<td>2.4</td>
<td>1.5</td>
<td>2.0</td>
<td></td>
<td>1.7</td>
<td>1.0</td>
<td>1.5</td>
<td></td>
<td>0.7</td>
<td>0.5</td>
<td>0.5</td>
<td></td>
<td>-0.4</td>
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<tr>
<td>Euro area</td>
<td>-6.0</td>
<td>1.7</td>
<td>0.9</td>
<td>1.3</td>
<td></td>
<td>0.7</td>
<td>0.9</td>
<td>1.2</td>
<td></td>
<td>1.1</td>
<td>0.0</td>
<td>0.1</td>
<td></td>
<td>1.8</td>
</tr>
<tr>
<td>Total of above OECD countries</td>
<td>-5.7</td>
<td>2.1</td>
<td>1.4</td>
<td>1.7</td>
<td></td>
<td>1.3</td>
<td>1.0</td>
<td>1.5</td>
<td></td>
<td>0.8</td>
<td>0.3</td>
<td>0.2</td>
<td></td>
<td>0.7</td>
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</table>

1. Percentage point contributions to potential employment growth.
2. Estimates of the structural rate of unemployment are from Gianellia et al. (2008), based on the concepts and methods described in OECD (2000).
3. Excluding the oil sector.

Source: OECD Economic Outlook 85 database.
Table 4.3. **Stylised medium-term scenario**

*Per cent*

<table>
<thead>
<tr>
<th></th>
<th>Real GDP growth</th>
<th>Inflation rate¹</th>
<th>Unemployment rate²</th>
<th>Long-term interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>3.2</td>
<td>2.2</td>
<td>2.5</td>
<td>7.7</td>
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<tr>
<td>Switzerland</td>
<td>2.1</td>
<td>0.6</td>
<td>1.1</td>
<td>5.1</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.7</td>
<td>1.0</td>
<td>2.1</td>
<td>9.7</td>
</tr>
<tr>
<td>United States</td>
<td>2.8</td>
<td>0.8</td>
<td>2.0</td>
<td>10.1</td>
</tr>
<tr>
<td>Euro area</td>
<td>2.3</td>
<td>0.7</td>
<td>2.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Total OECD</td>
<td>2.7</td>
<td>0.8</td>
<td>2.0</td>
<td>9.8</td>
</tr>
</tbody>
</table>

*Note:* For further details see OECD Economic Outlook Sources and Methods (http://www.oecd.org/eco/sources-and-methods).
1. Percentage change from the previous period in the private consumption deflator.
2. Per cent of labour force.
3. Including oil-sector.

*Source:* OECD Economic Outlook 85 database.
Figure 4.6. Output Decomposition
(Percent of precrisis trend; mean difference from year $t = -1$; first year of crisis at $t = 0$; years on x-axis)
Sources: Bosworth and Collins (2003); World Bank, World Development Indicators; and IMF staff calculations.
What Policies Are Associated w/Small Declines?

• Aggressive macroeconomic support at the time of the crisis start
• Structural adjustment:
  - domestic financial reform,
  - capital account and trade liberalization
  - structural fiscal reform
• Lower global short term interest rates