



# **Almost Six Years since the Burst of the Crisis: Did We Choose the Right Way to Get Out of the Great Recession?**

30<sup>th</sup> May 2013

Fabio Sdogati, [fabio.sdogati@polimi.it](mailto:fabio.sdogati@polimi.it)

Daniele Langiu, [daniele.langiu@mail.polimi.it](mailto:daniele.langiu@mail.polimi.it)

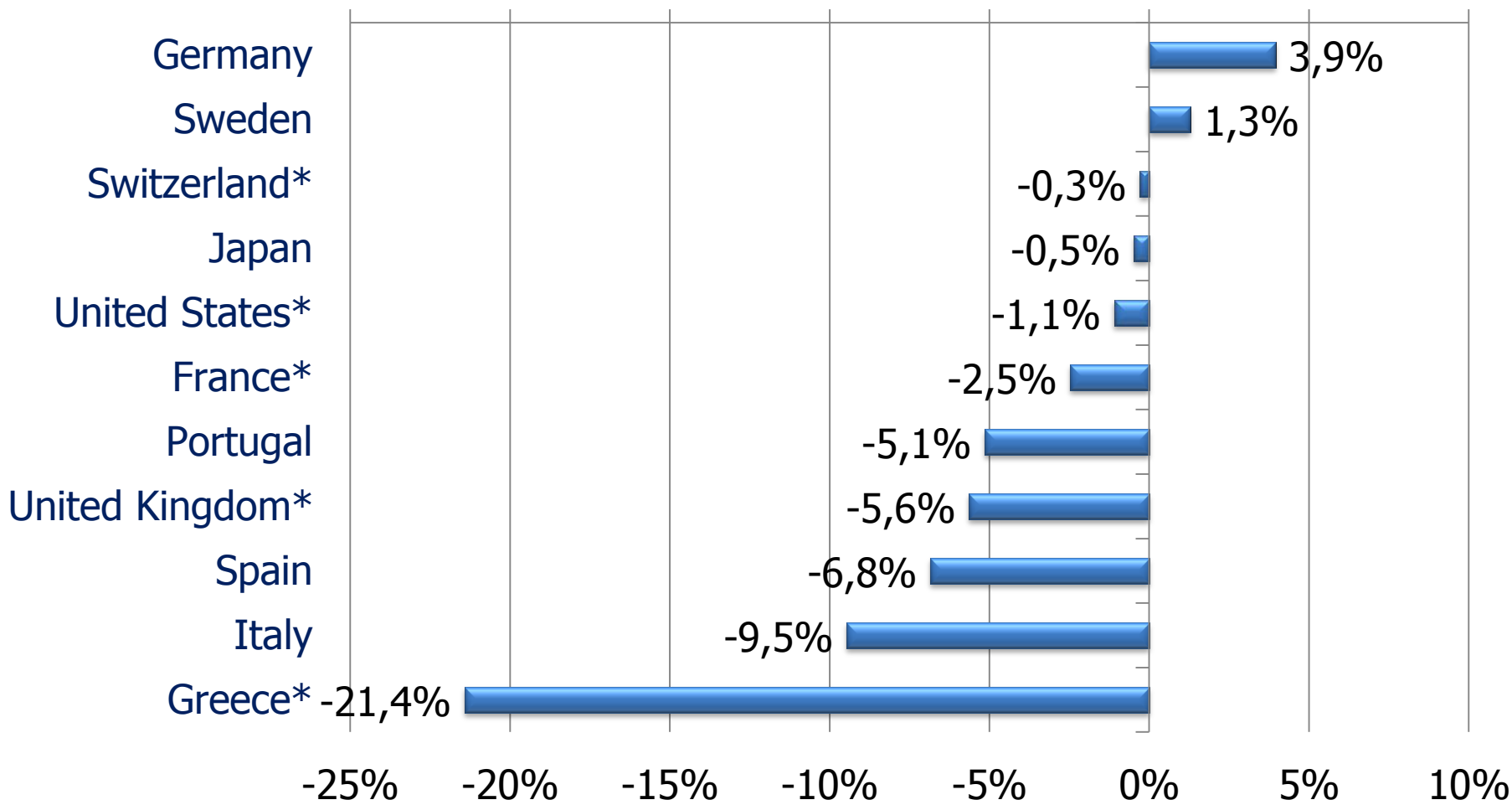
Francesco Morello, [francesco.morello@mail.polimi.it](mailto:francesco.morello@mail.polimi.it)

# Table of Contents

1. The Great Recession
2. A European crisis or an attack against the Euro?
3. What future for the European Union?
4. The Great Recession and its Implications
5. Austerity Kills

## 1.1 The Great Recession: the Plunge in GDP

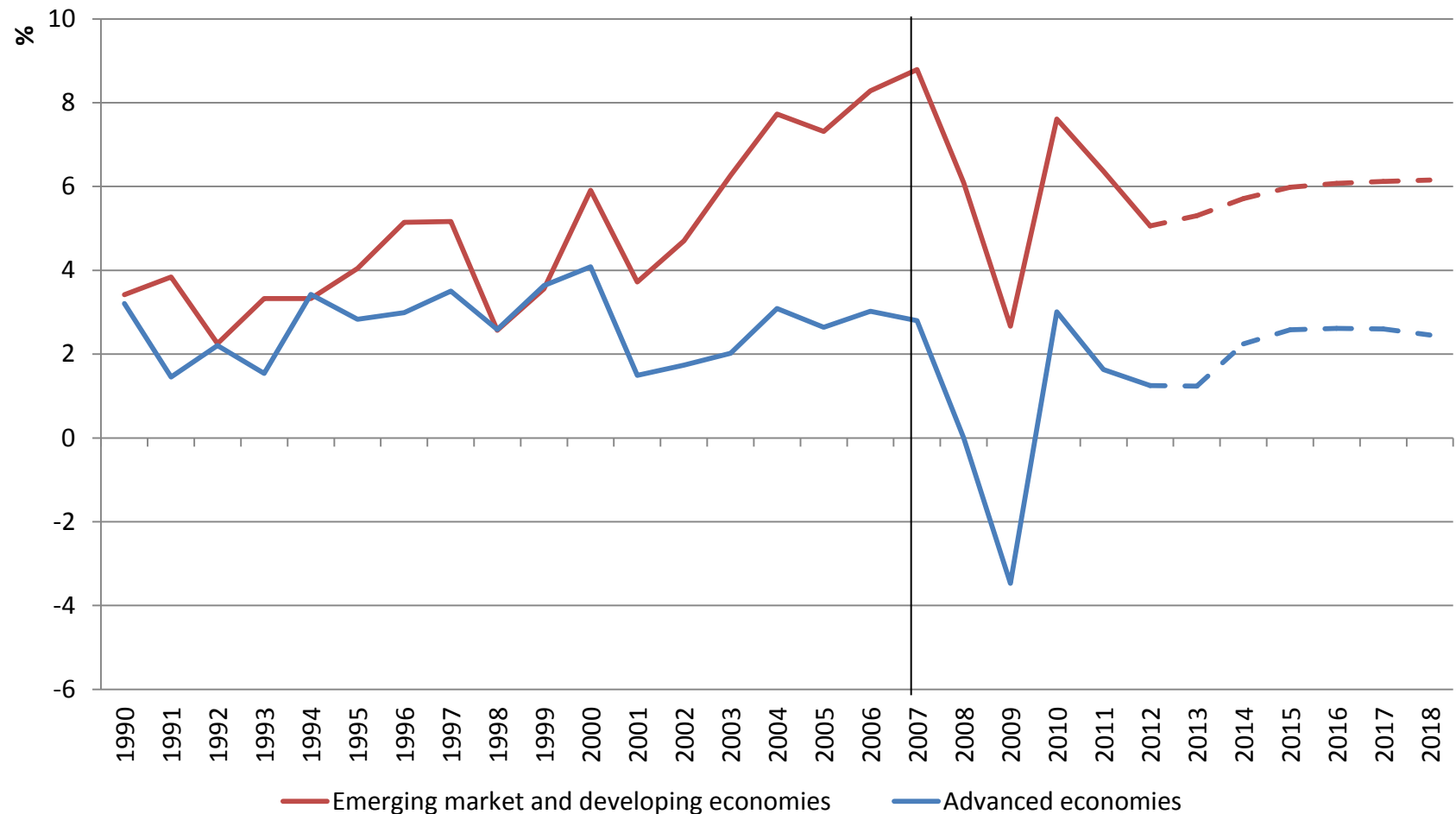
The impact of the Great Recession: Real per-capita GDP, cumulative change over the period 2007-2012



Source: IMF, World Economic Outlook Database, April 2013; \*estimates for 2012

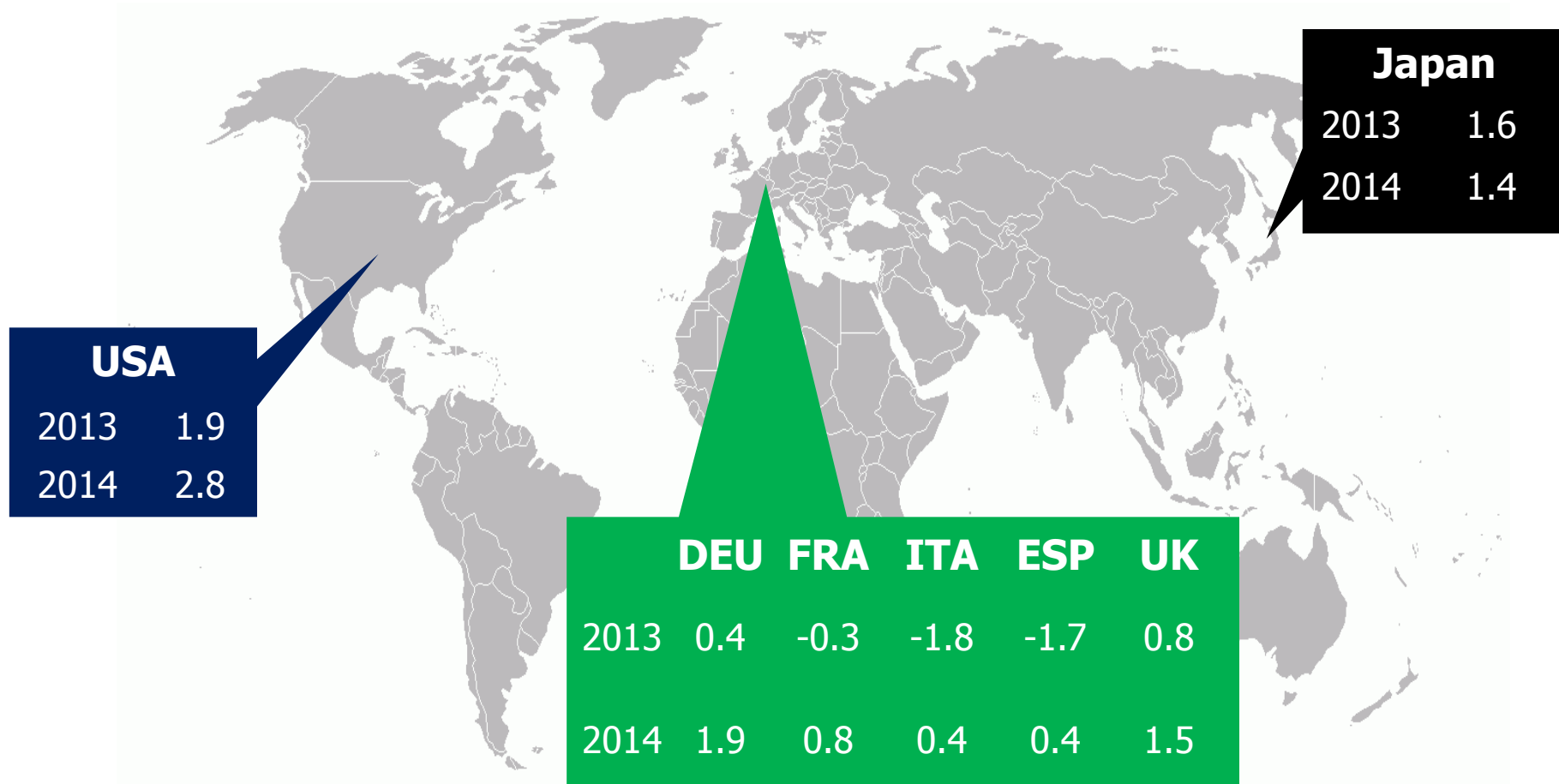
## 1.2 The Great Recession: the Economic Scenario

From the year 2000, there has been a decoupling between emerging and developing economies and high per-capita income economies.



## 1.2 The Great Recession: the Economic Scenario

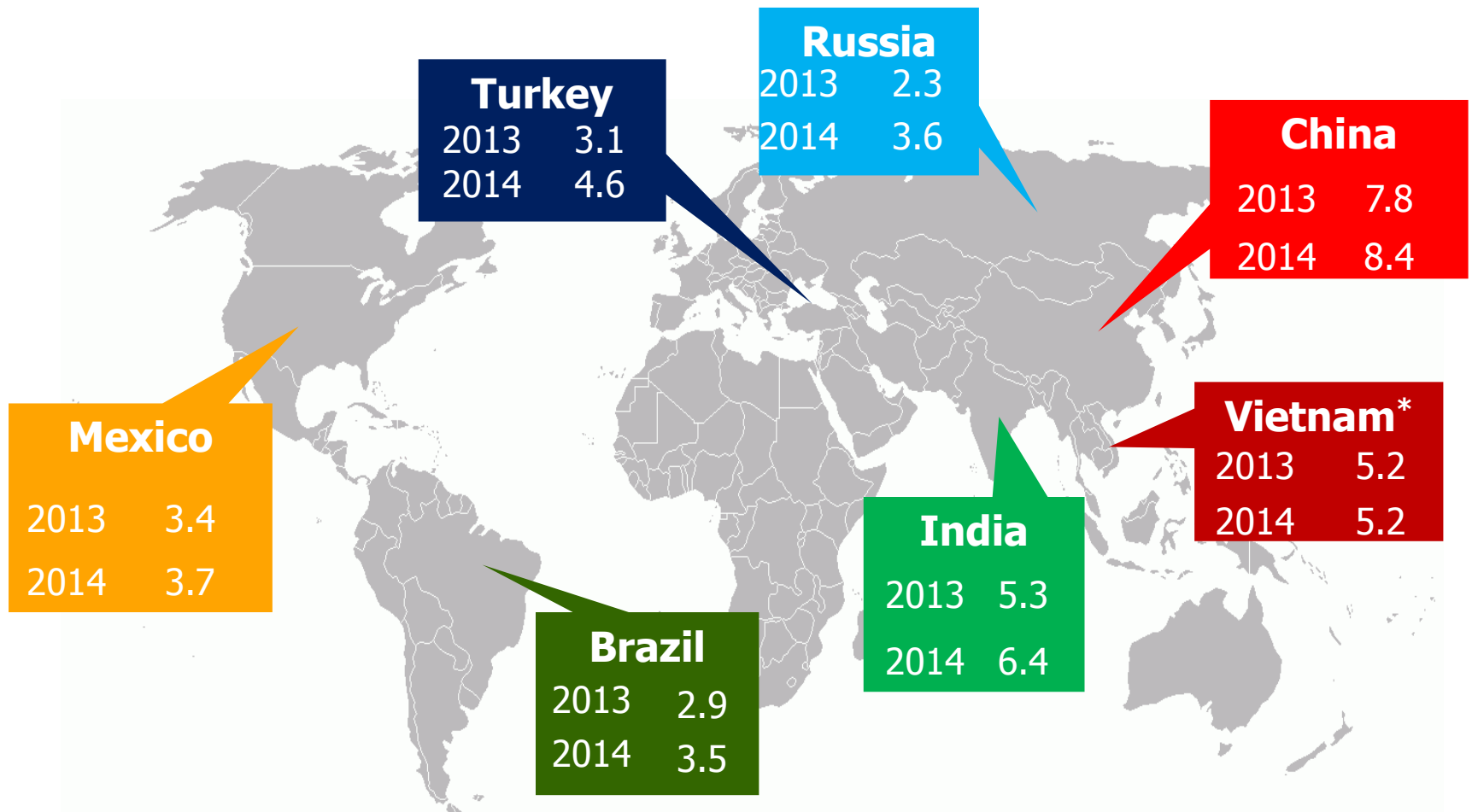
Real GDP growth rate forecasts for the years 2013 and 2014. Since April 16<sup>th</sup>, growth forecasts have worsened.





## 1.2 The Great Recession: the Economic Scenario

Real GDP growth rate forecasts for the years 2013 and 2014.



Sources: OECD Economic Outlook, 29th May 2013; \*IMF, World Economic Outlook April 2013;

## 1.2 The Great Recession: the Economic Scenario

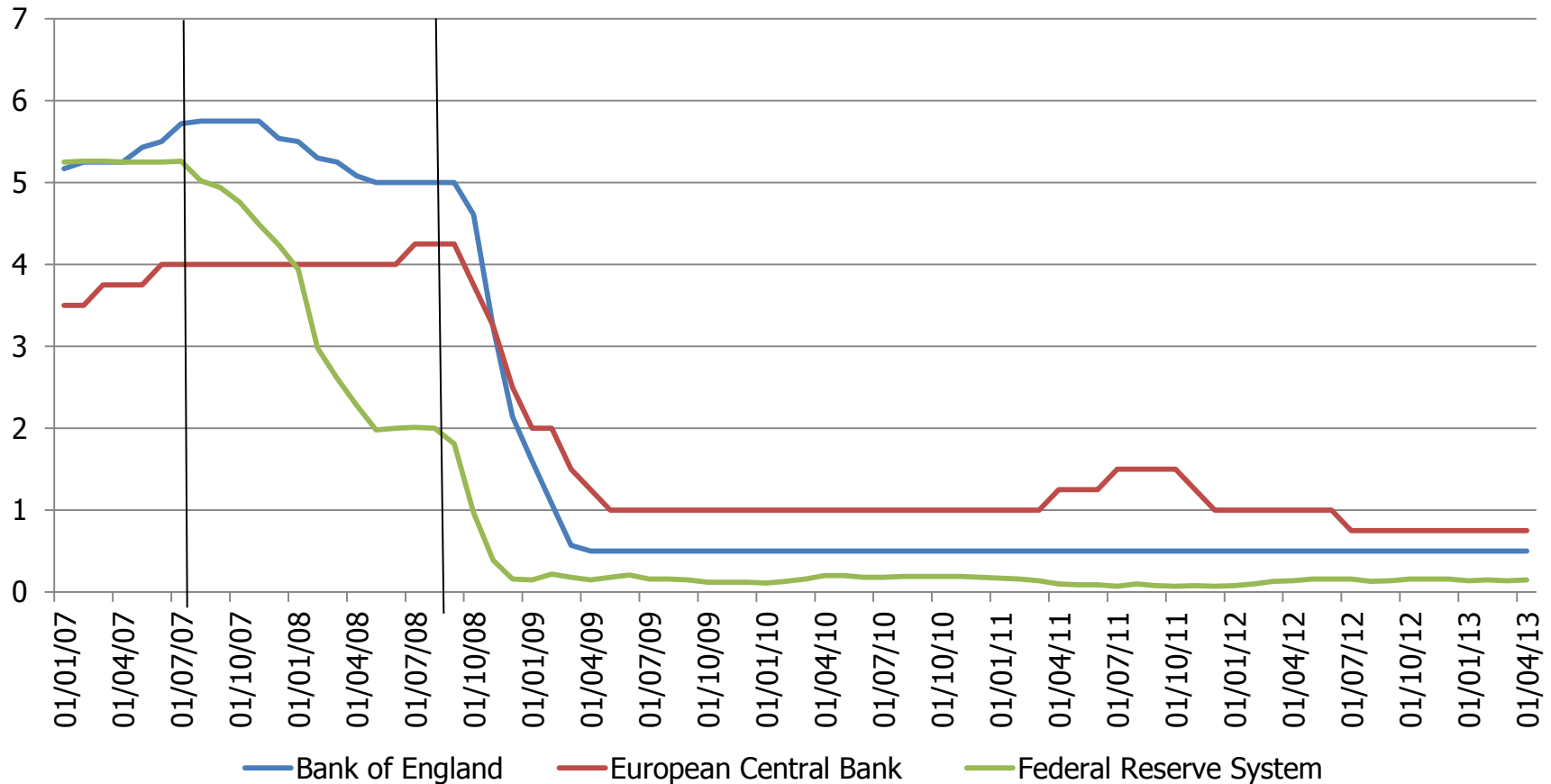
### Forecasts – Real GDP growth for the year 2013

<i>Country</i>	<i>Dec. 2011</i>	<i>Apr. 2012</i>	<i>Jun. 2012</i>	<i>Jul. 2012</i>	<i>Oct. 2012</i>	<i>Nov. 2012</i>	<i>Jan. 2013</i>	<i>April 2013</i>	<i>May 2013</i>
<b>USA</b>	2.5	2.4	2.6	2.3	2.1	2.6	2.0	1.9	1.9
<b>UK</b>	1.8	2	1.9	1.4	1.1	1.9	1.0	0.7	0.8
<b>Germany</b>	1.9	1.5	2.0	1.4	0.9	2.0	0.6	0.6	0.4
<b>Italy</b>	1.6	-0.3	-0.4	-0.3	-0.7	-0.4	-1.0	-1.5	-1.8
<b>France</b>	1.4	1	1.2	0.8	0.4	1.2	0.3	-0.1	-0.3
<b>Spain</b>	1.3	0.12	-0.8	-0.6	-1.3	-0.8	-1.5	-1.6	-1.7
<b>Japan</b>	1.6	1.7	1.5	1.5	1.2	1.5	1.2	1.6	1.6
<b>Brazil</b>	3.9	4.15	4.2	4.6	4.0	4.2	3.5	3.0	2.9
<b>Russia</b>	4.1	3.9	4.1	3.9	3.8	4.1	3.7	3.4	2.3
<b>India</b>	n.a.	7.3	7.7	6.5	6.0	7.7	5.9	5.7	5.3
<b>China</b>	9.5	8.8	9.3	8.5	8.2	9.3	8.2	8.0	7.8
<b>Turkey</b>	4.5	3.2	4.6	n.a.	3.5	4.6	n.a.	3.4	3.1
<b>Mexico</b>	3.6	3.65	3.8	3.6	3.5	3.8	3.5	3.4	3.4

Sources: OECD EO90 (Dec 2011), IMF WEO (Apr. 2012), OECD EO91 (June 2012), IMF WEO Update (July 2012), IMF WEO (Oct. 2012), OECD EO92 (Nov. 2012), IMF WEO Update (January 2013); IMF WEO (April 2013); OECD EO93 (May 2013).

## 1.3 Monetary Policy and Fiscal Policy Reactions

Main refinancing operation rates of three major central banks, Jan 2007 – April 2013 (monthly averages)

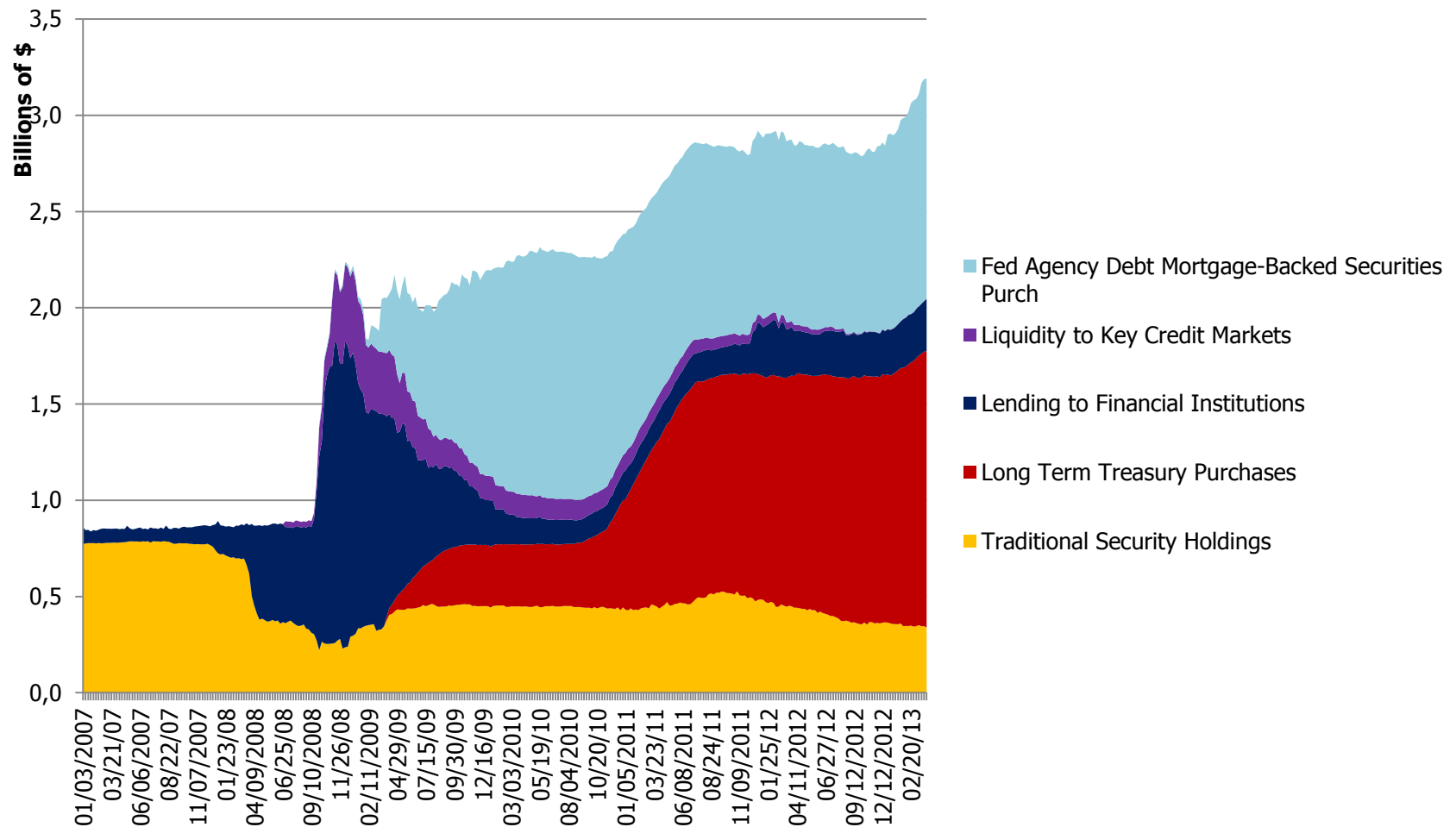


Source: Federal Reserve, European Central Bank, Bank of England, May 2013; \*On 2<sup>nd</sup> May 2013 ECB cuts its refinancing rate to 0,50%.



## 1.3 Monetary Policy and Fiscal Policy Reactions

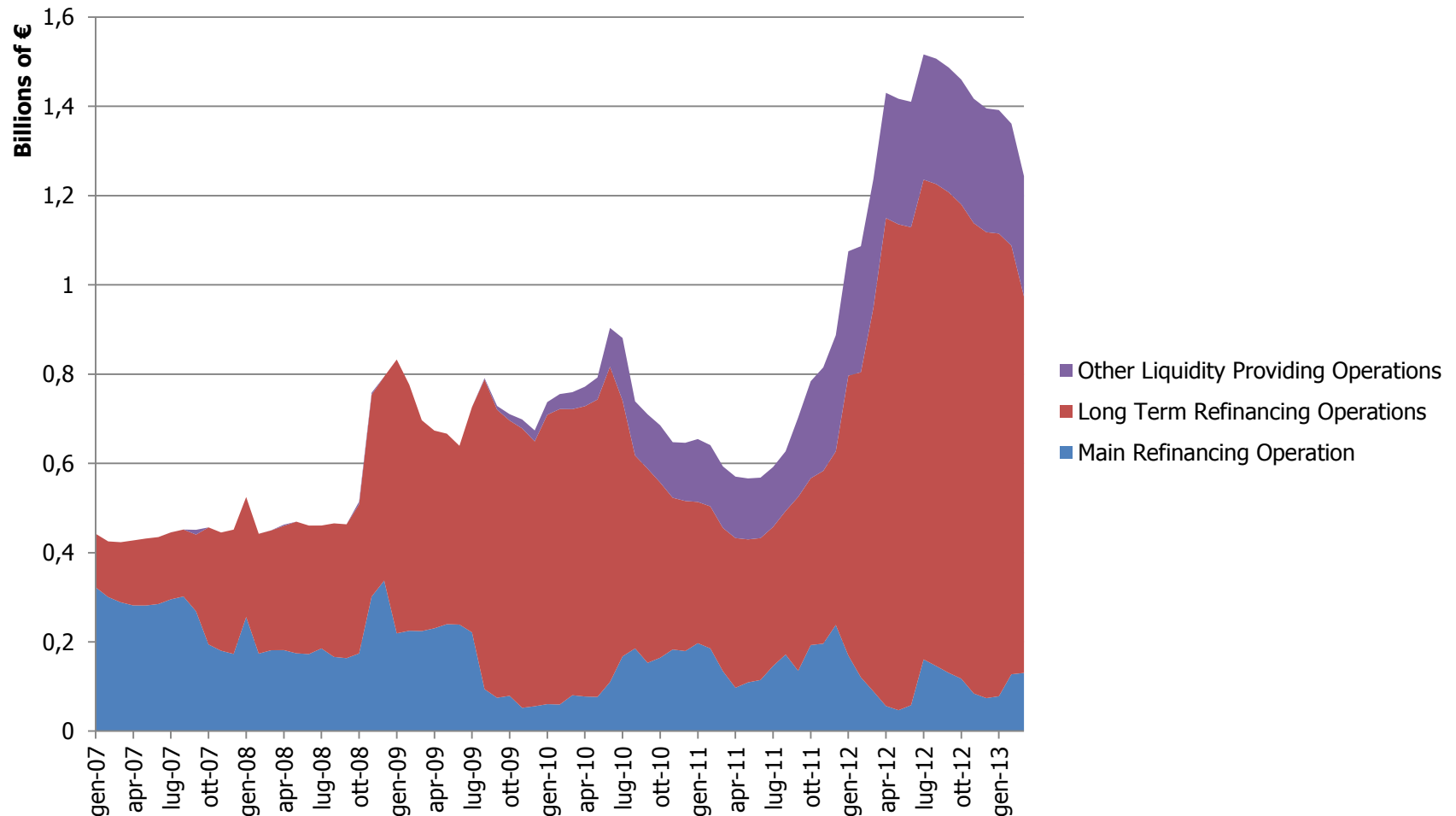
Federal Reserve System balance sheet main items, monthly data, jan-07 – feb 2013



Source: Federal Reserve Bank of Cleveland, April 2013

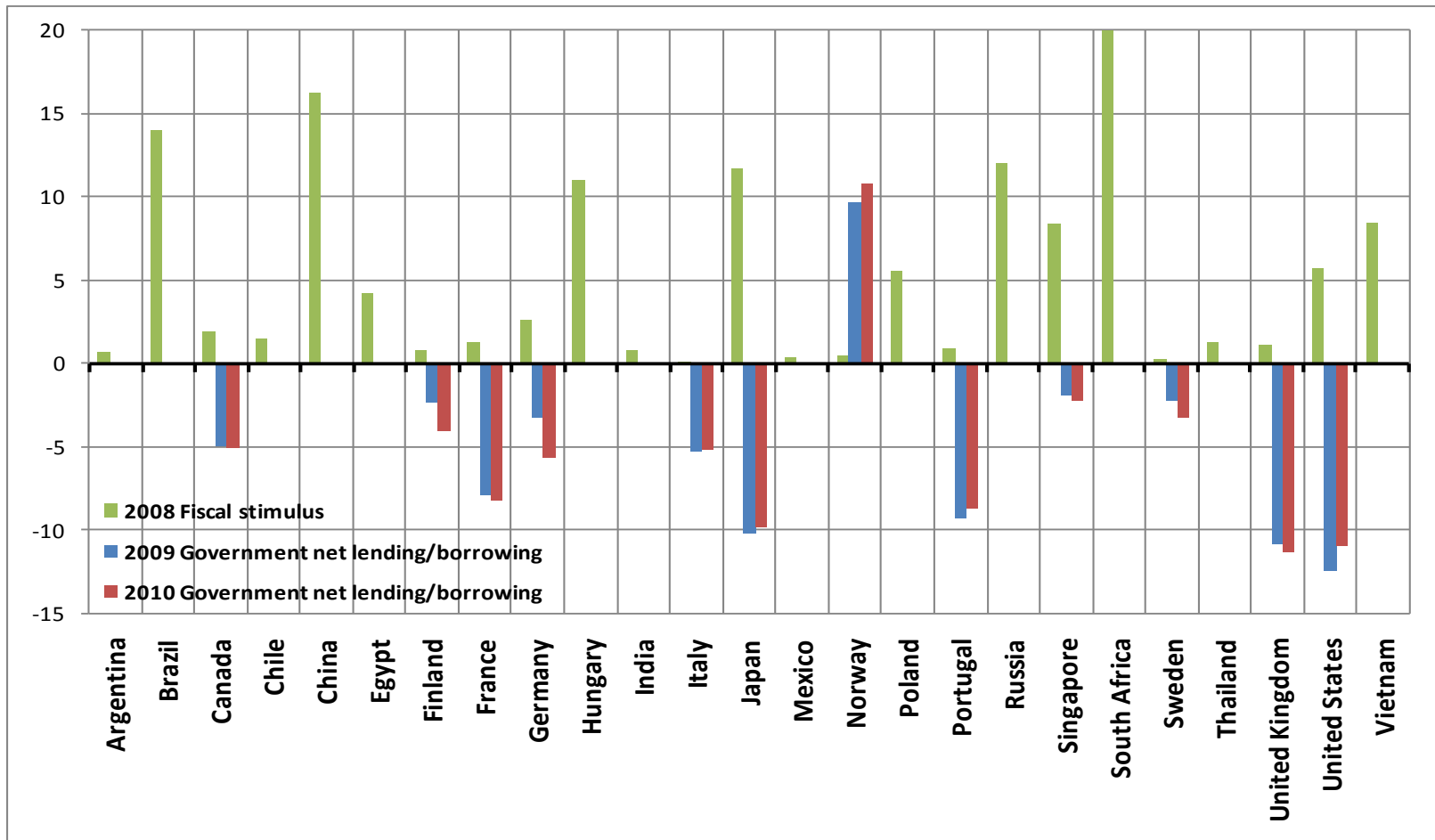
## 1.3 Monetary Policy and Fiscal Policy Reactions

European Central Bank balance sheet main items, monthly data, jan-07 – feb 2013



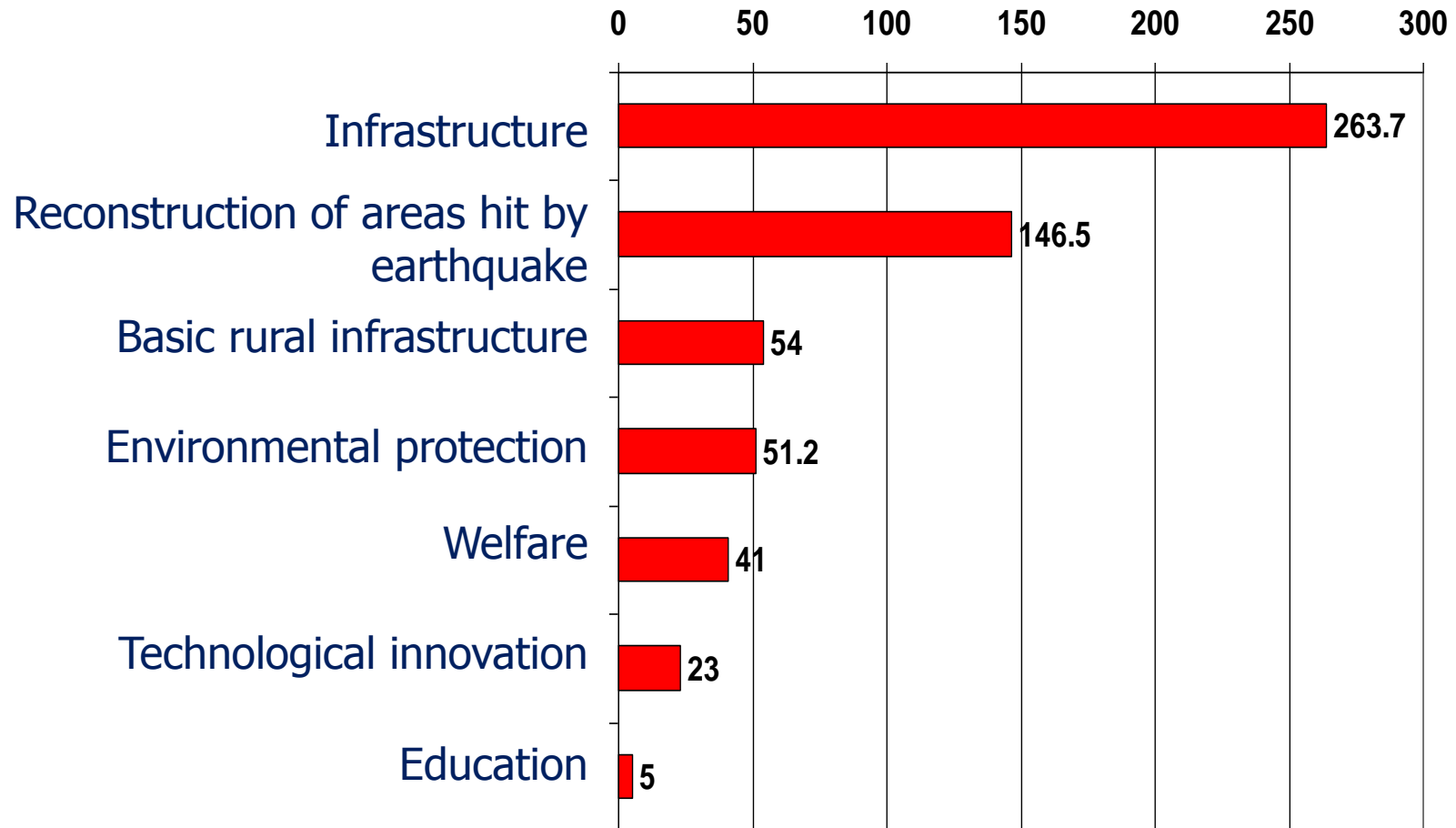
## 1.3 Monetary Policy and Fiscal Policy Reactions

Fiscal stimuli enacted to counter the crisis and public deficits 2009 and 2010 (% of GDP)



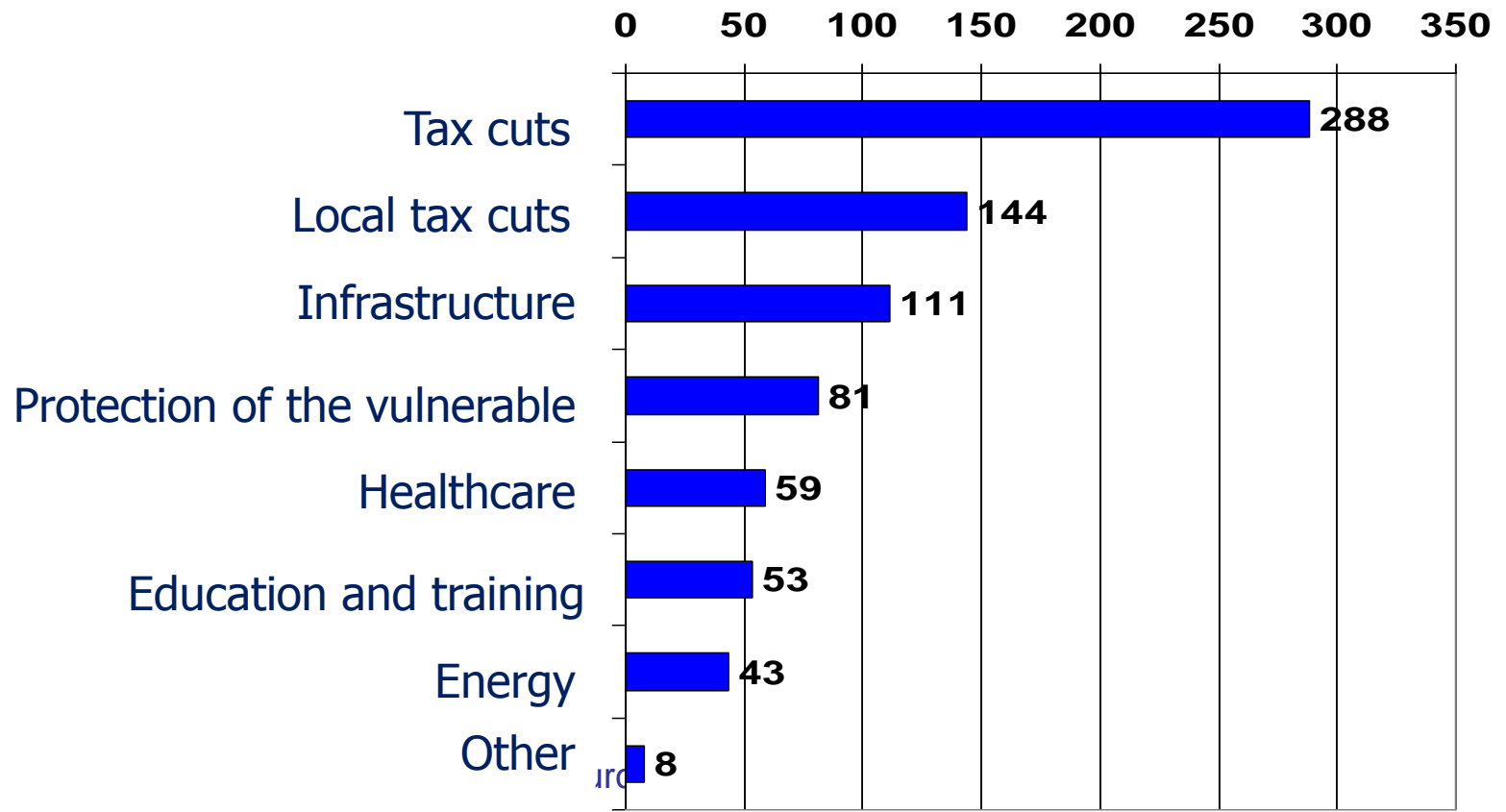
## 1.3 Monetary Policy and Fiscal Policy Reactions

November 2008: Chinese public spending plan (\$ billion)



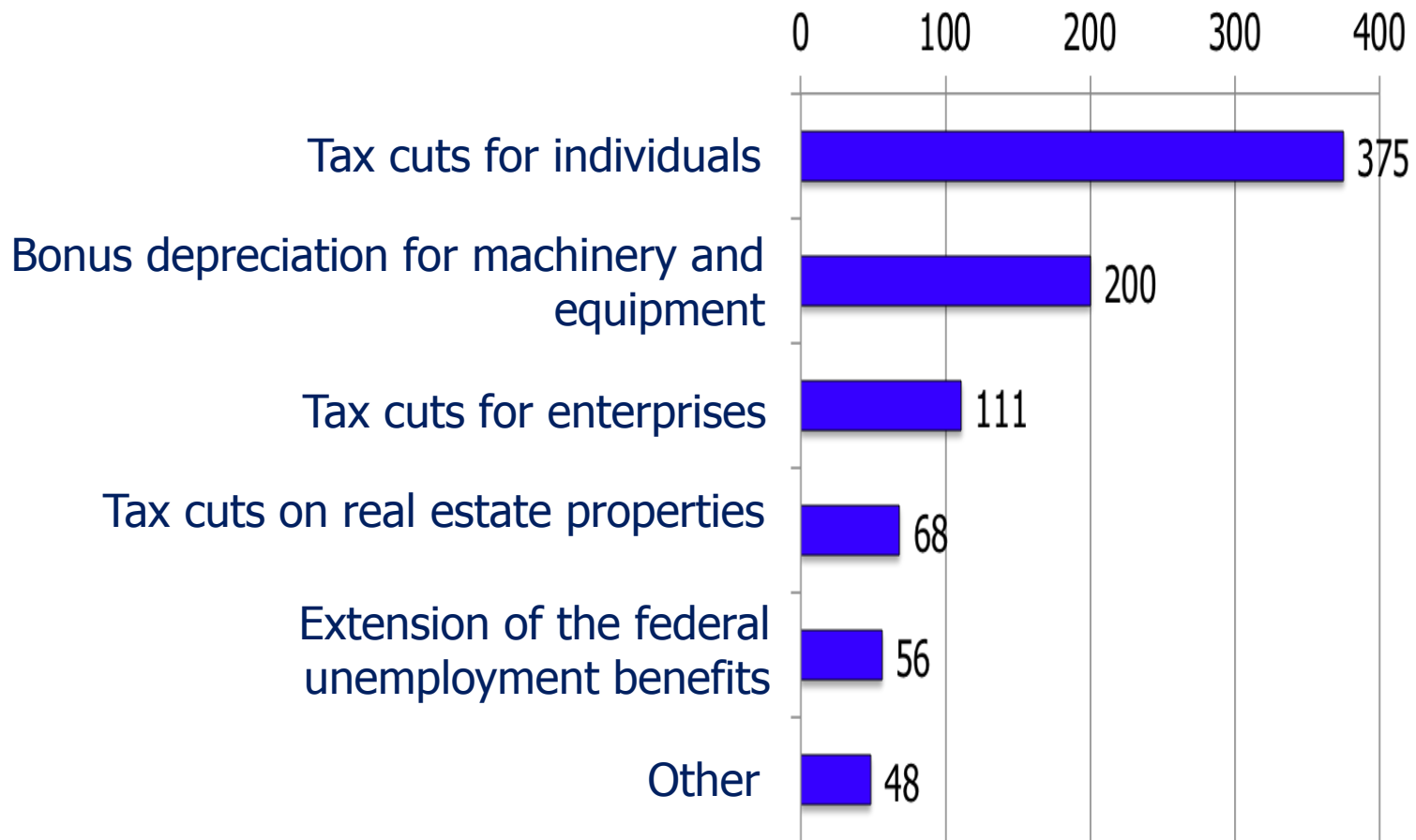
## 1.3 Monetary Policy and Fiscal Policy Reactions

February 2009: The American Recovery and Reinvestment Plan (\$ billion)



## 1.3 Monetary Policy and Fiscal Policy Reactions

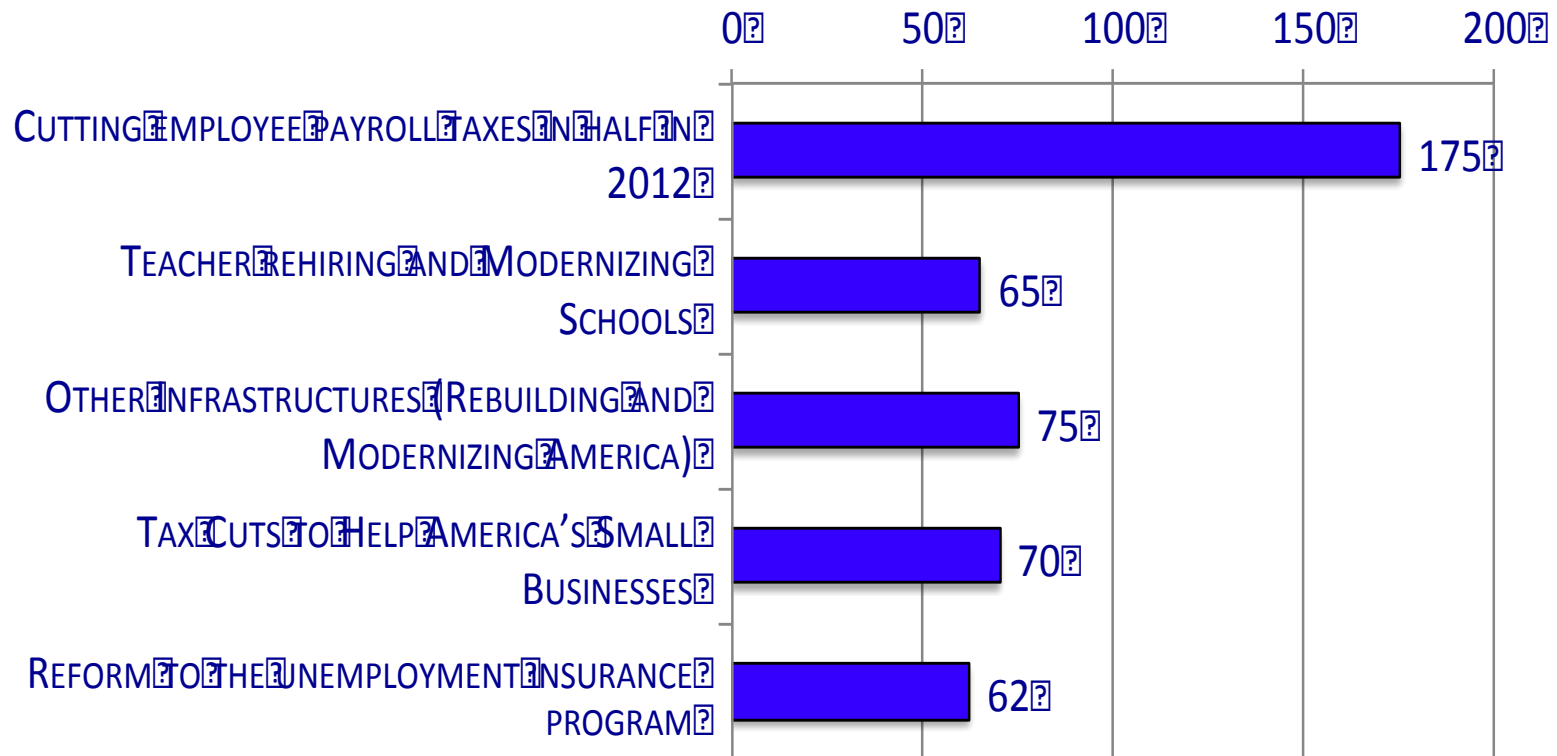
December 2010: the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (\$ billion)





## 1.3 Monetary Policy and Fiscal Policy Reactions

September 2011: the American Jobs Act – President Obama's plan to create jobs now (447\$ billion)\*



Source: [www.whitehouse.gov](http://www.whitehouse.gov)

\*Congress did not actually authorized the whole package, which was then cut in parts approved over time;

## 1.4 The Great Recession: Increasing Inequalities

The «marginal-productivity theory» justified the vast inequalities in income: higher incomes were associated with higher productivity and a greater contribution to society.

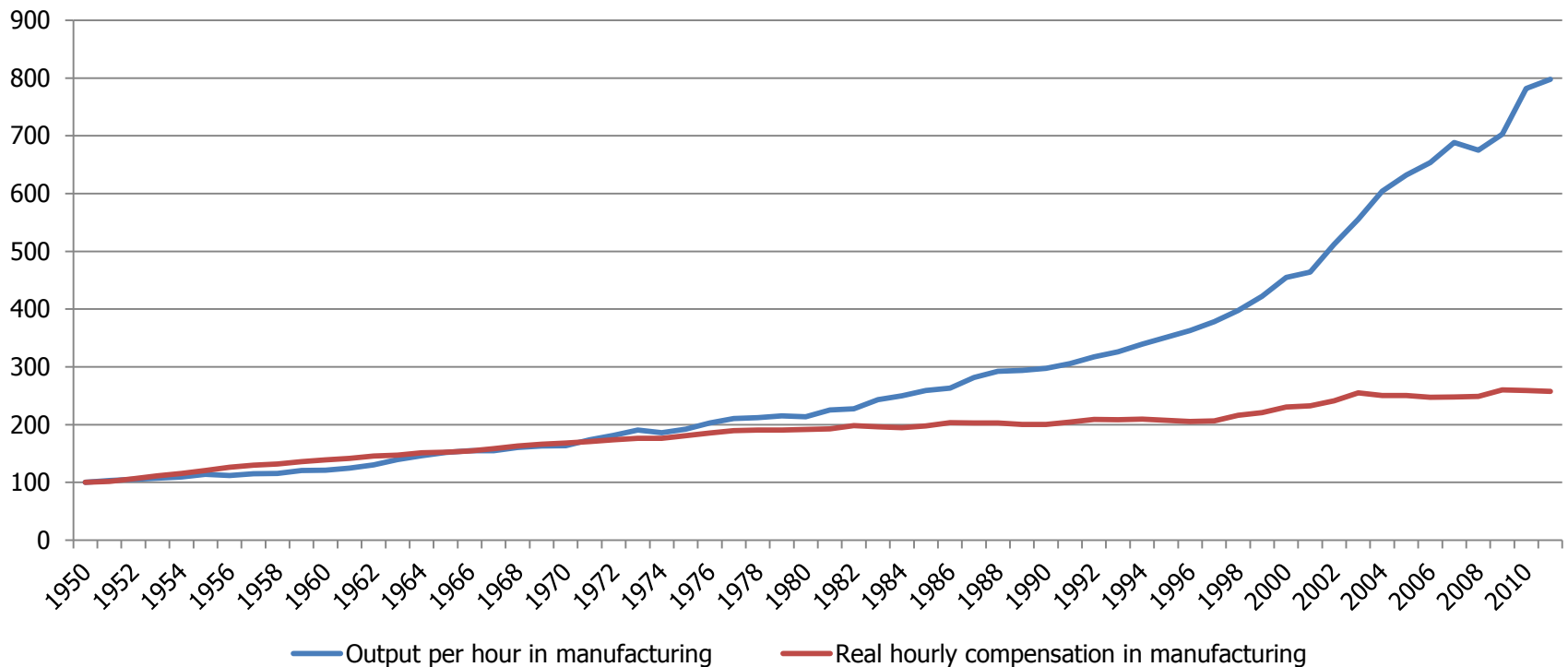


Evidence for its validity remains thin.  
(Joseph Stiglitz, May 2011)

## 1.4 The Great Recession: Increasing Inequalities

From the late 1970s, the middle class began to weaken: productivity continued to grow but wages began flattening, because of growing automation in the production processes.

Productivity Index and Real Compensation Index in US manufacturing industry, annual data, 1950 (=100) – 2011.



## 1.4 The Great Recession: Increasing Inequalities

Gini Coefficient (before taxes and transfers). The values of the Gini coefficient range between 0, in the case of "perfect equality" (i.e. each share of the population gets the same share of income), and 1, in the case of "perfect inequality" (i.e. all income goes to the individual with the highest income).

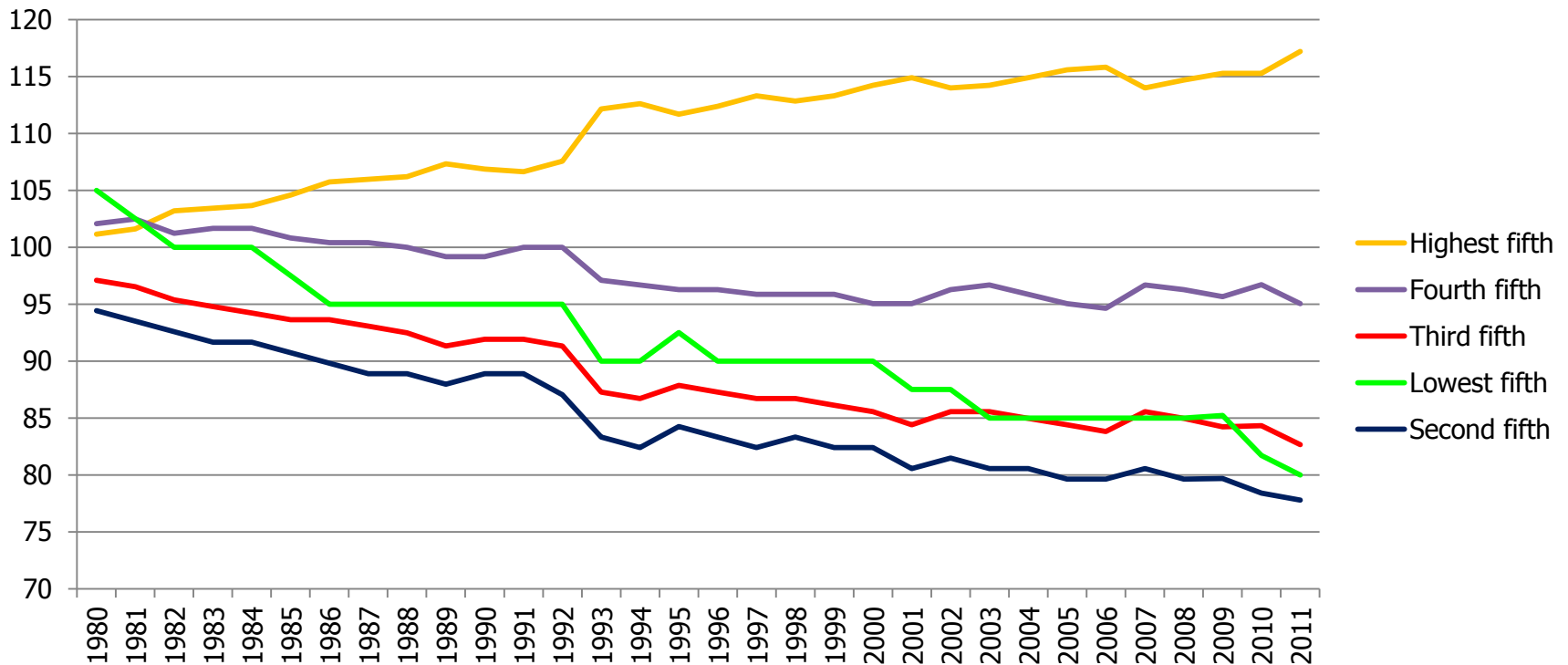
	mid-70s	mid-80s	around 1990	mid-90s	around 2000	mid-2000s	late-2000s	Change over all periods
<b>France</b>	n.a.	n.a.	n.a.	0,47	0,49	0,49	0,48	-
<b>Germany</b>	n.a.	0,44	0,43	0,46	0,47	0,50	0,50	+
<b>Greece</b>	0,45	0,43	n.a.	0,45	0,47	0,45	0,44	-
<b>Italy</b>	n.a.	0,42	0,44	0,51	0,52	0,56	0,53	+
<b>Japan</b>	n.a.	0,35	n.a.	0,40	0,43	0,44	0,46	+
<b>Mexico</b>	n.a.	0,45	n.a.	0,53	0,52	0,49	0,49	+
<b>Netherlands</b>	0,43	0,47	0,47	0,48	0,42	0,43	0,43	=
<b>Portugal</b>	0,46	n.a.	0,44	0,49	0,48	0,54	0,52	+
<b>Sweden</b>	0,39	0,40	0,41	0,44	0,45	0,43	0,43	+
<b>United Kingdom</b>	0,34	0,42	0,44	0,45	0,51	0,50	0,51	+
<b>United States</b>	0,41	0,44	0,45	0,48	0,48	0,49	0,49	+
<b>OECD - Average</b>	n.a.	0,41	n.a.	0,46	0,46	0,47	0,46	+

Source: OECD, Social and Welfare Statistics, February 2013

## 1.4 The Great Recession: Increasing Inequalities

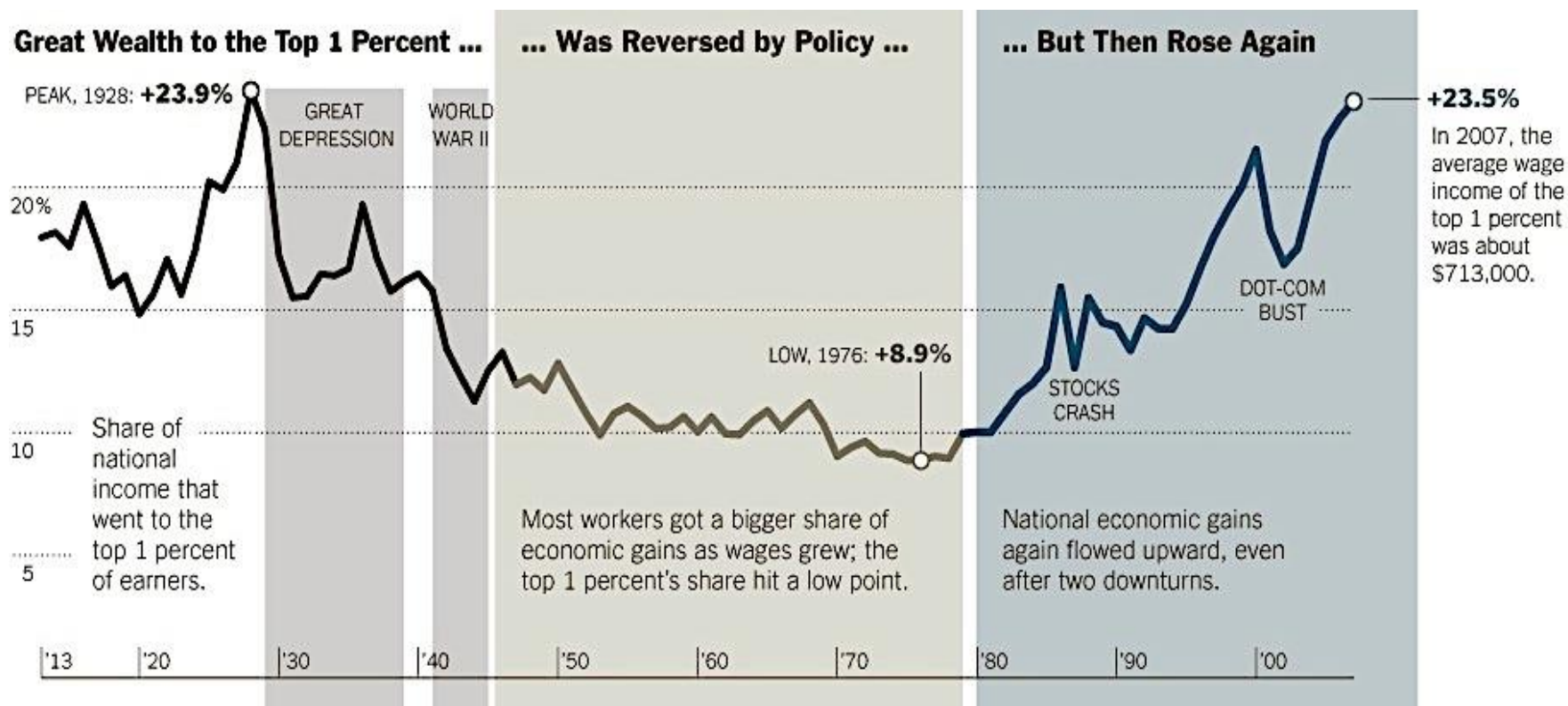
«We have a society in which money is increasingly concentrated in the hands of a few people, and in which that concentration of income and wealth threatens to make us a democracy in name only» (Paul Krugman)

U.S. aggregate income share received by each fifth, 1980-2011 (1967=100)



Sources: Krugman P., Oligarchy, American Style (New York Times, 14<sup>th</sup> November 2011); Source: OECD, Social and Welfare Statistics, May 2013

## 1.4 The Great Recession: Increasing Inequalities



It seems that during periods when the very rich took home a much smaller proportion of total income the Usa as whole grew faster and median wages surged. Instead, during periods when the very rich took a home a larger proportion, growth slowed and median wages stagnated



## 2.1 The Causes of the Attack against Euro

European indebtedness is not radically different from the Us's or Japan, but:

1. If compared to Us or Japan, Europe is in a position of disadvantage, relatively to sovereign credit risk, because it **lacks a fiscal coordination among countries**
2. Great financial institutions, mainly European, own a great part of the debt (not only sovereign debt)

*The euro crisis had its origin in German Chancellor Angela Merkel's decision, taken in the aftermath of Lehman Brothers' default in September 2008, that the guarantee against further defaults should come not from the European Union, but from each country separately*

George Soros, 2011

## 2.2 The Causes of the Attack against Euro

Both the increase in government debt and government deficit seem to be not the cause of the crisis but the necessary consequence of both the decrease in GDP and employment.

*«So yes, debt matters. But right now, other things matter more. We need more, not less, government spending to get us out of our unemployment trap. And the wrongheaded, ill-informed obsession with debt is standing in the way»*

Paul Krugman, January 2012

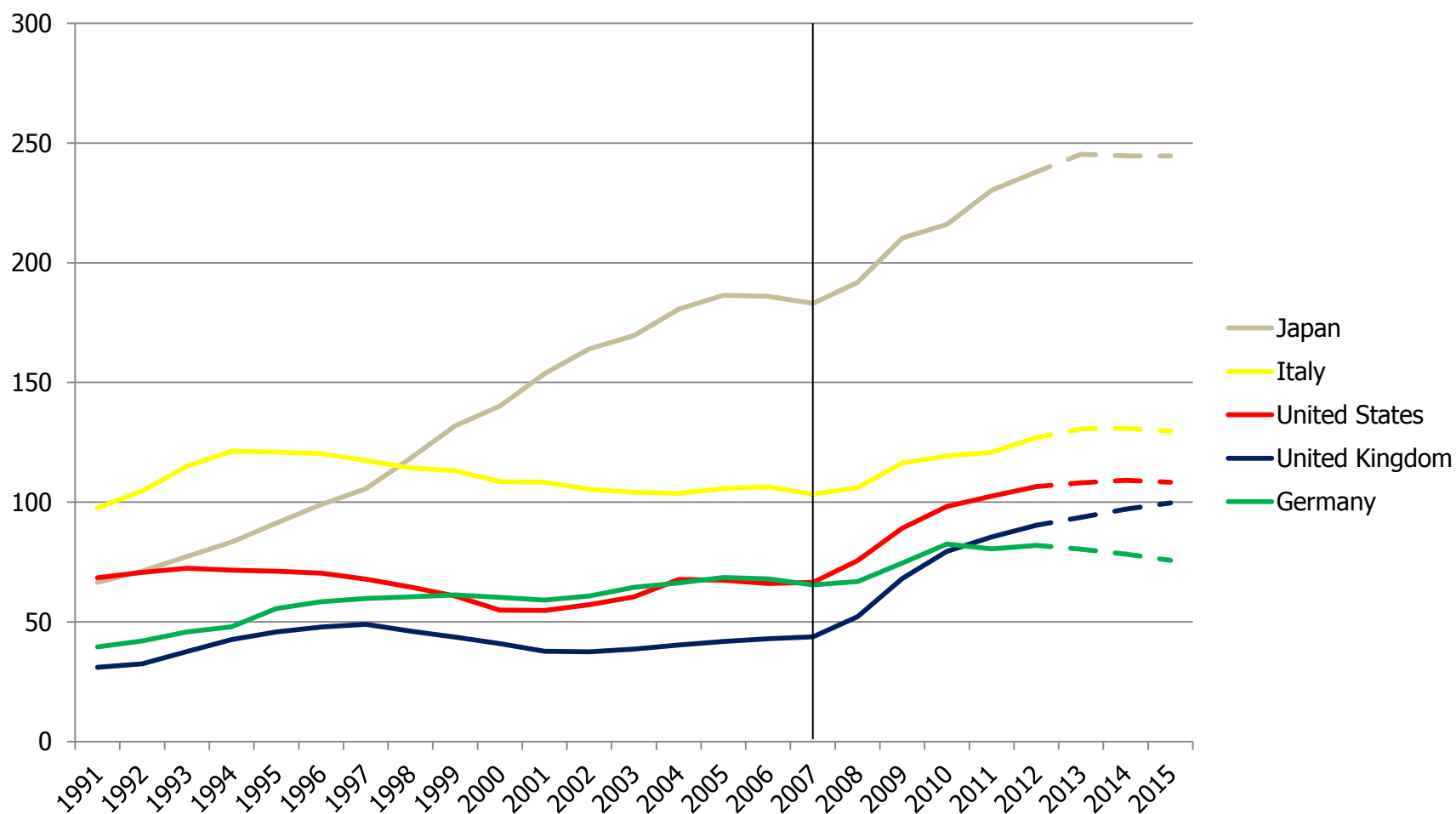
## 2.2 The Causes of the Attack against Euro

Some stylized fact about recent debt issues:

1. Already before the crisis, many governments were heavily indebted, including some European countries, USA and Japan. Moreover, these countries were showing an increase in projected debt/GDP ratio;
2. After the crisis burst in 2007, governments pledged (other) substantial resources in order to support the financial system and aggregate demand;
3. Given the present welfare model, it is the world's destiny to witness more public debt, not less;
4. Consequently, the real issue is how to finance a huge public debt whose tendency is to grow.

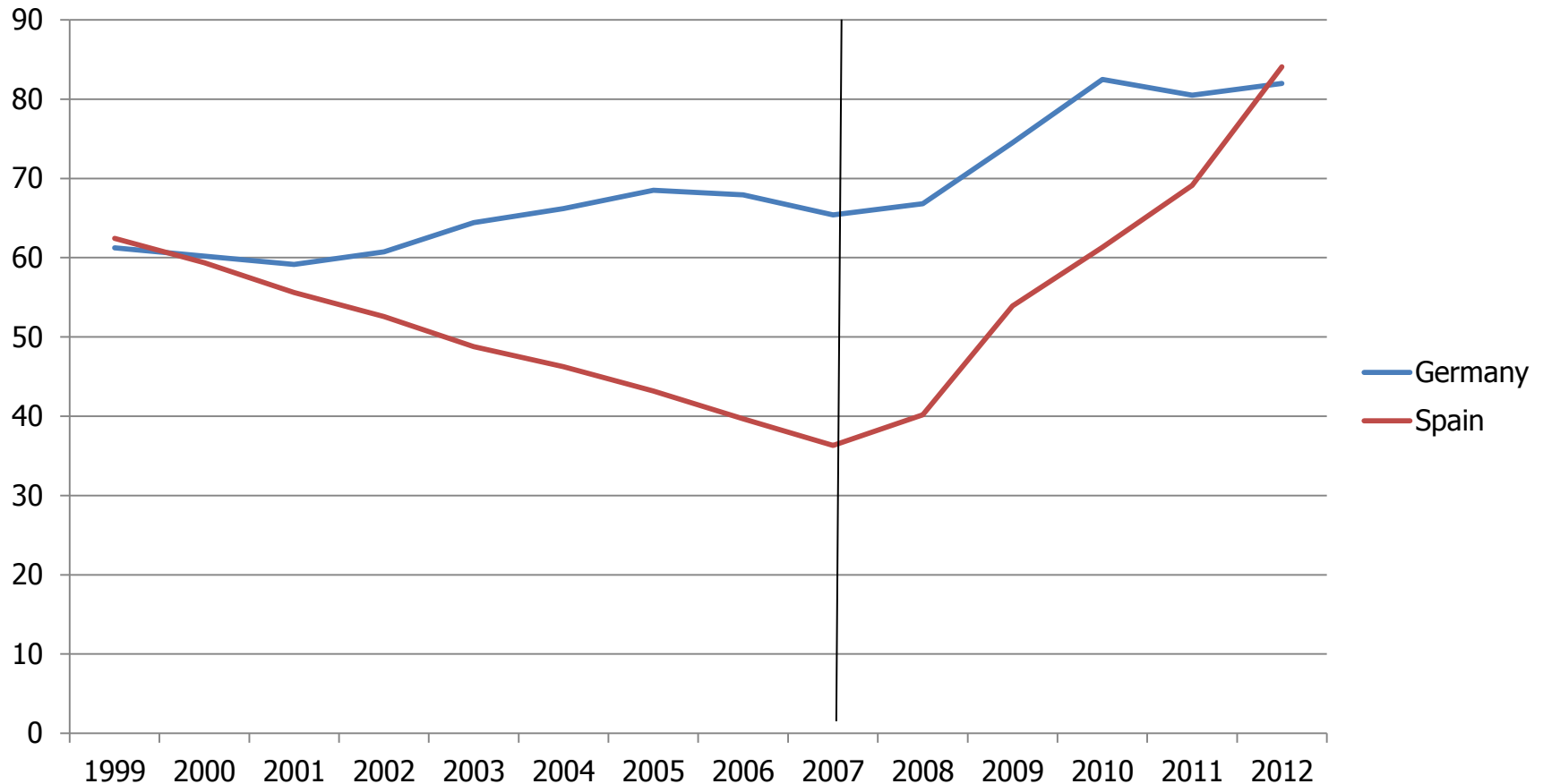
## 2.2 The Causes of the Attack against Euro

General government gross debt of the main high per-capita income countries (as a percentage of GDP), estimates after 2012



## 2.2 The Causes of the Attack against Euro

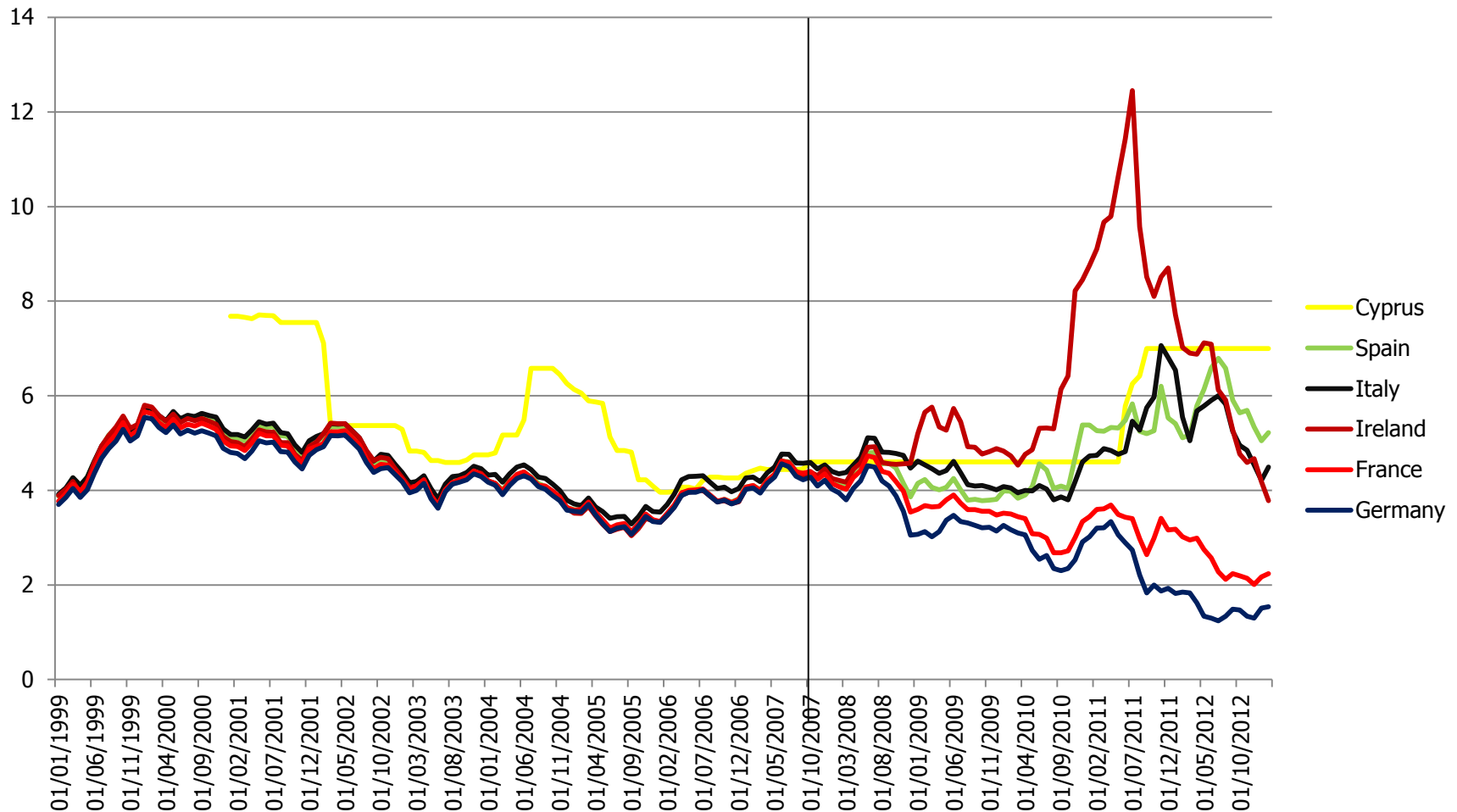
General government debt (as a % GDP)



Do you still believe it is a problem of fiscal responsibility?

## 2.2 The Causes of the Attack against Euro

Harmonized long-term interest rates (%). The rates are secondary market yields of government bonds with a remaining maturity close to ten years, monthly data, Jan 1999 – Jan 2013 .





### 3.1 Fiscal Compact: pros and cons

«Today we agreed to move toward a stronger economic union. This implies action in two directions:

1. a new fiscal compact and strengthened economic policy coordination;
2. the development of our stabilisation tools to face short term challenges.»

European Council (Brussels, 9<sup>th</sup> December 2011)

Fiscal Compact (Title III of the **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union**) was signed on 2<sup>nd</sup> March 2012. The treaty entered into force on 1 January 2013, if by that time 12 members of the euro area have ratified it.

### 3.1 Fiscal Compact: pros and cons

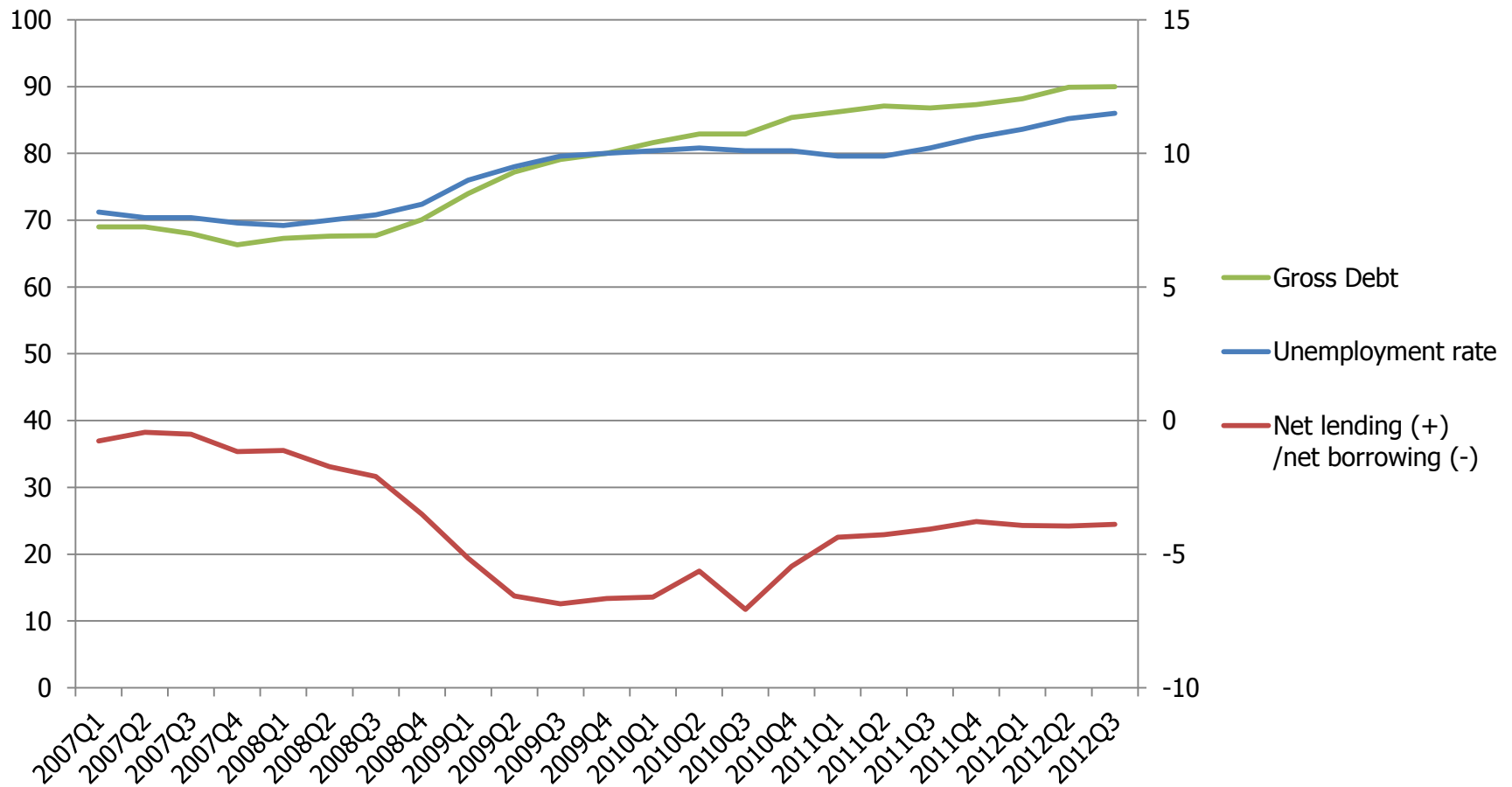
1. General government budget shall be balanced or in surplus. The annual structural deficit must not exceed 0,5% of nominal GDP. Countries with government debt levels significantly below 60 percent and where risks in terms of long-term sustainability of public finances are low, can reach a structural deficit of at most 1 percent of GDP;
2. Such a rule will also be introduced in Member States' national legal systems at constitutional or equivalent level;
3. Member states shall converge towards their specific reference level;
4. Member States in Excessive Deficit Procedure shall submit to the Commission and the Council for endorsement, an economic partnership programme detailing the necessary structural reforms to ensure an effectively durable correction of excessive deficits;
5. A mechanism will be put in place for the ex ante reporting by Member States of their national debt issuance plans.

## 3.2 The Effects of European Austerity

1. A restrictive fiscal policy in a sort of liquidity trap:
  1. reduces deficit by cutting expenditures, but
  2. there is the risk of inducing a recession, and consequently there would be a lower tax revenue and an increasing deficit
  3. if GDP decreases, as a consequence debt/GDP ratio grows
  4. if the recession induces deflation, the real debt will grow
2. Austerity's implications:
  1. Enhancing the risk of a new recession
  2. Need to question some successes of the welfare state
  3. Policy without "vision"

## 3.2 The Effects of European Austerity

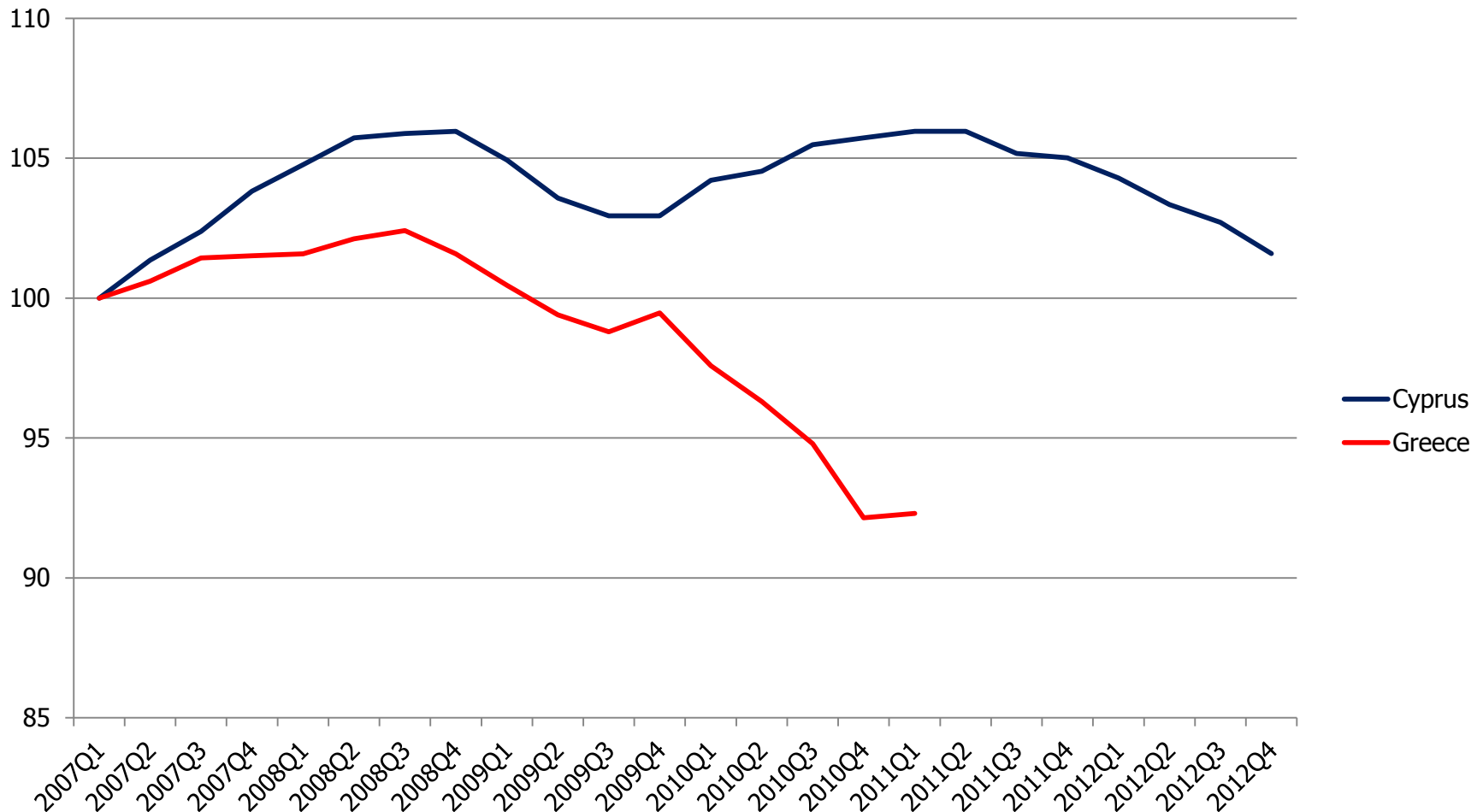
Euro area Total Debt of Governments (left axis) and Primary Deficit (right axis) as a percentage of GDP and Total Unemployment Rate (right axis).



Source: Eurostat, Accessed on March 2013

### 3.3 Eurozone Unsolved Problems

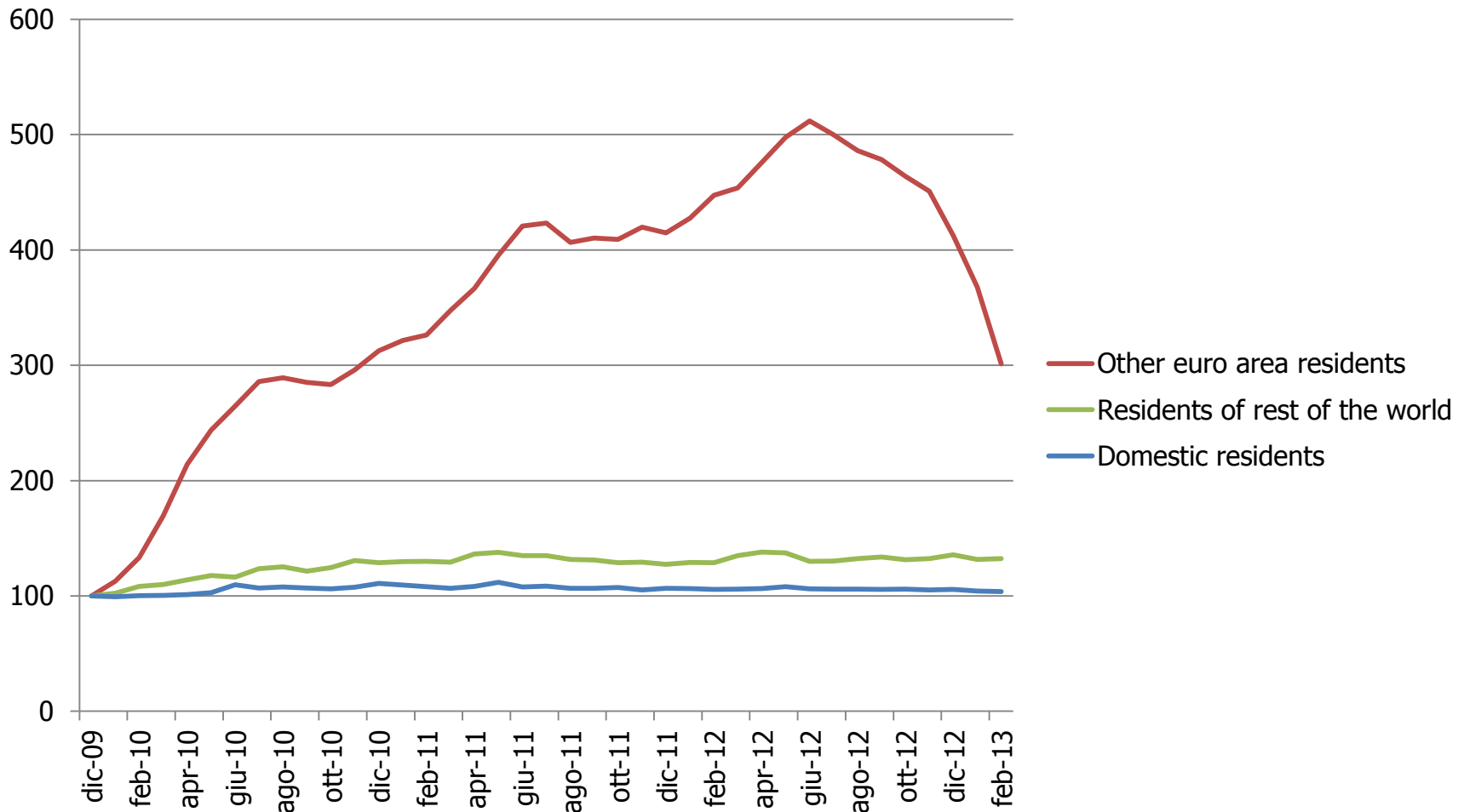
The cases of **Greece** and **Cyprus**: Greek gross domestic product index (2007Q1-2011Q1) and Cypriot gross domestic product index (2007Q1-2012Q4), quarterly and seasonally adjusted data (2007Q1=100).



Source: Eurostat, April 2013

### 3.3 Eurozone Unsolved Problems

Cyprus: Outstanding total deposit of non-financial institutions held with main financial institutions, monthly data (Dec 2009=100 – Feb 2013)



Source: Central Bank of Cyprus, April 2013



## 4.1 Should We Be Worried About Inflation?

On 12<sup>th</sup> December, the **US Federal Reserve** decided to focus on labor market:

1. It will keep interest rates at close to zero until unemployment falls below 6.5%;
2. In addition, it beefed up its third round of quantitative easing to \$85bn and it keep buying mortgage-backed securities.

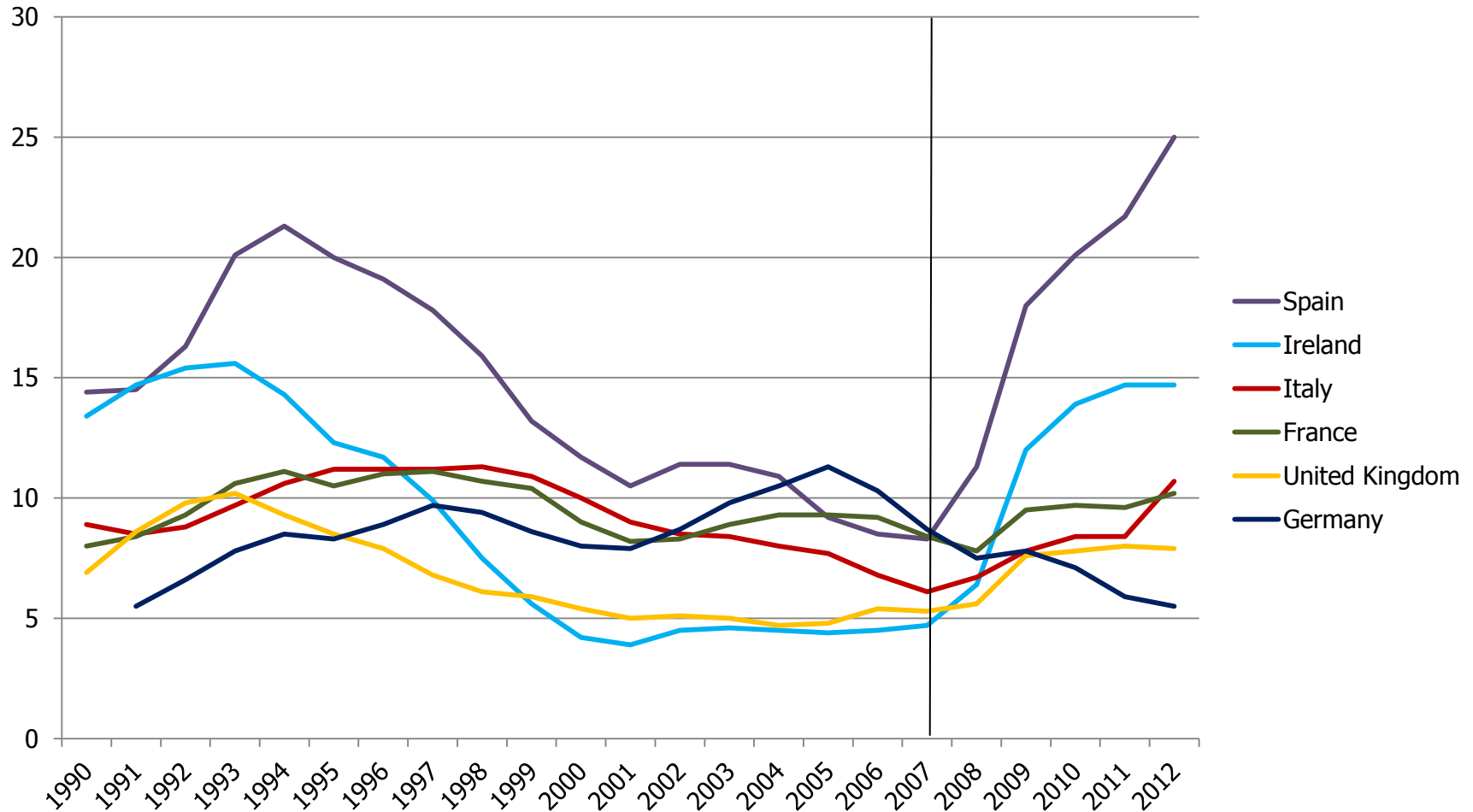
Mr. Carney, next Governor of the **Bank of England**, suggested setting targets for the overall size of the economy, or nominal gross domestic product, rather than inflation;

The Japan's prime-minister, Shinzo Abe, began pushing the **Bank of Japan** to adopt a more aggressive monetary policy in an effort to boost economic growth.

...and the **European Central Bank**?

## 4.2 The Real Matter of Concern: Unemployment

### Unemployment rate (%), in the main European Countries, 1990-2012



Source: Eurostat, April 2013

## 4.2 The Real Matter of Concern: Unemployment

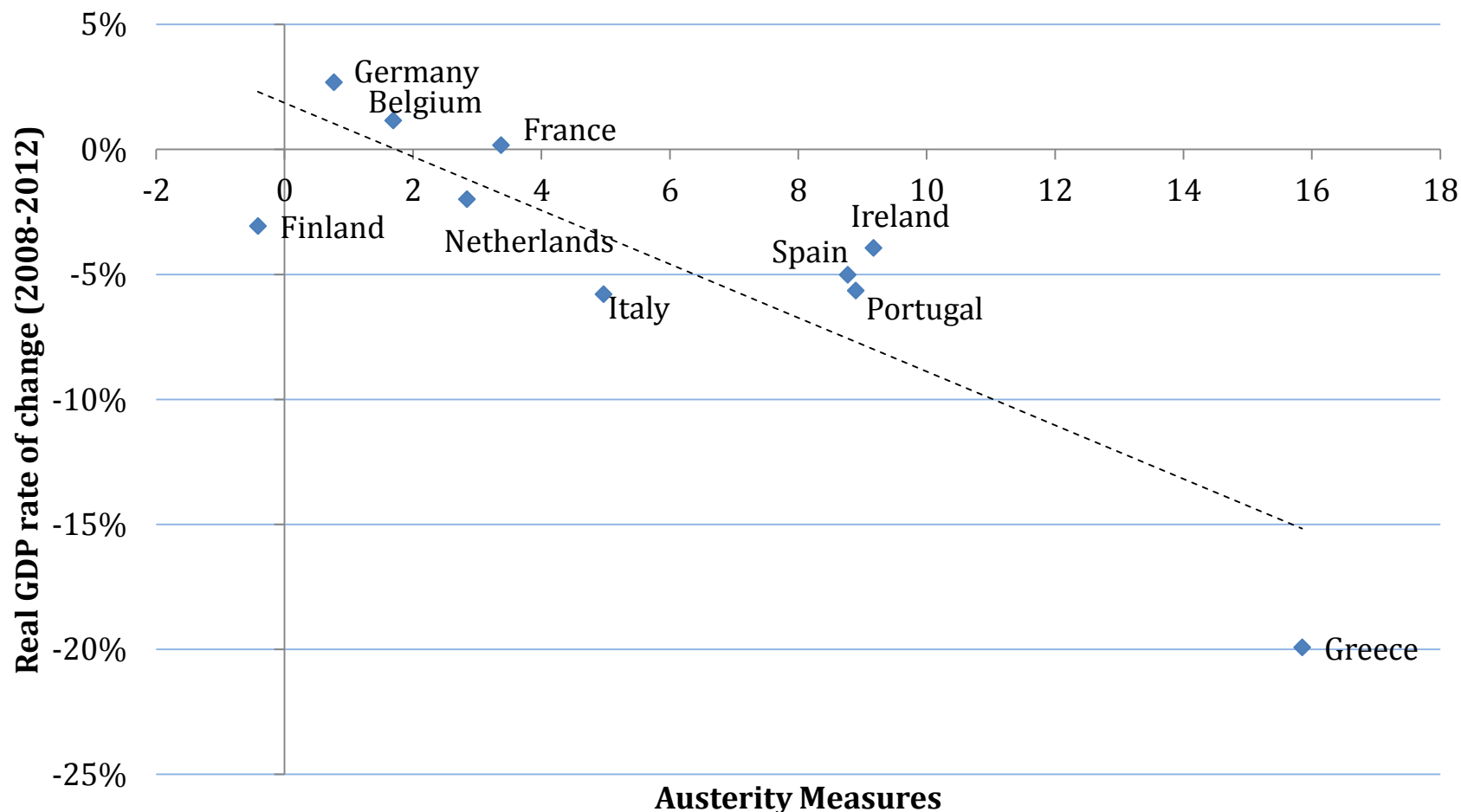
So, should we be worried about inflation? In the long term, the inflation rate will increase. We are sure about that as we know that we will die.

Maybe the question does not deserve such concern. Rather, we should ask ourselves if would we prefer a growing unemployment and deeper recession (that means unemployment and deflation) now or greater inflation in the long term?

In the 1930s, policy makers chose the first option, and we all know how it ended.

## 5. Austerity Kills

Austerity measures\* – spending cuts and tax increases 2009-2012 – as a share of GDP, as estimated by the International Monetary Fund and real per-capita GDP growth

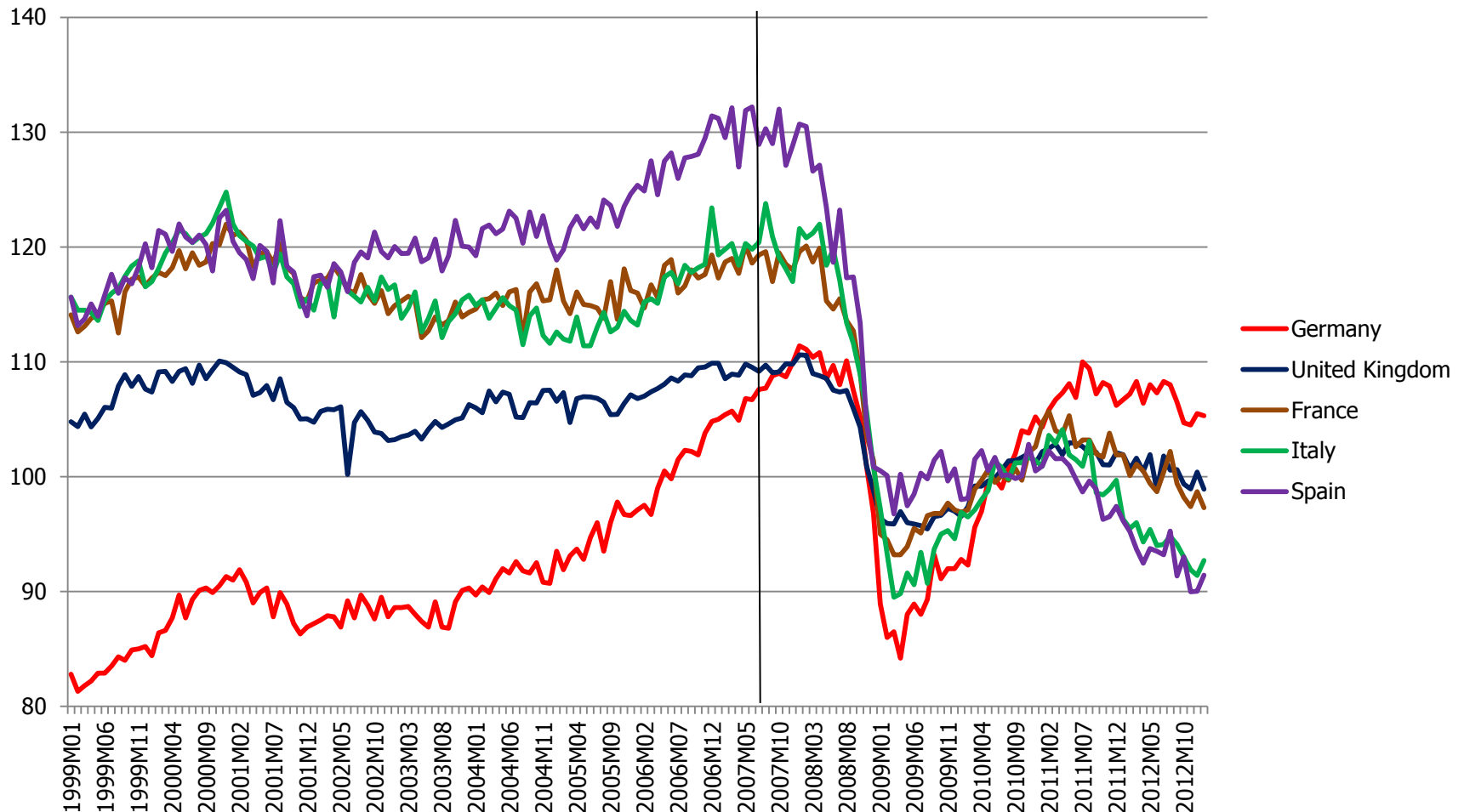


Source: IMF, World Economic Outlook, April 2013; IMF Fiscal Monitor, October 2012;

\* Austerity measures are defined as the cyclically adjusted primary balance (CAPB) needed to reduce debt; this is the CAPB required in 2020 to reduce the debt-to-GDP ratio to appropriate levels, as defined in IMF Statistical Tables

## 5. Austerity Kills

**Industrial production index** in manufacturing (2010=100), monthly seasonally adjusted data, 1999M01-2013M1



## 5. Austerity Kills

Thousands of unemployed in March 2007 and in March 2013, and absolute change over the period.

(x1000)	March 2007	March 2013	Change
Germany	3.718	2.291	<b>-1.427</b>
Spain	1.759	6.080	<b>4.321</b>
France	2.477	3.254	<b>777</b>
Italy	1.455	2.950	<b>1.495</b>
Netherlands	321	573	<b>252</b>
Portugal	505	939	<b>434</b>

Source: Eurostat, May 2013

	Unit	2007	2012	Change
Real GDP	millions of €	2000	1860	-7%
Unemployment (total)	x1000 per	2000	1717	83%
Unemployment (Female)	x1000 per	1274	1274	63%
Unemployment (Male)	x1000 per	1475	1475	104%
Unemployment (15-24 years)	x1000 per	380	611	61%
Healthcare Government Expenditure	current €	1651	1718	4%
Education Government Expenditure	current €	937	758	-19%
		<b>Aug.2007</b>	<b>Dec.2012</b>	<b>% Change</b>
Industrial Production Index (2010=100)	Index	122,3	91,3	-25%

Source: IS

AUSTERITY KILLS