CAREC SEMINAR ON MACROECONOMIC AND FINANCIAL STABILITY

CYCLICAL MACRO POLICIES IN CAREC COUNTRIES

Astana

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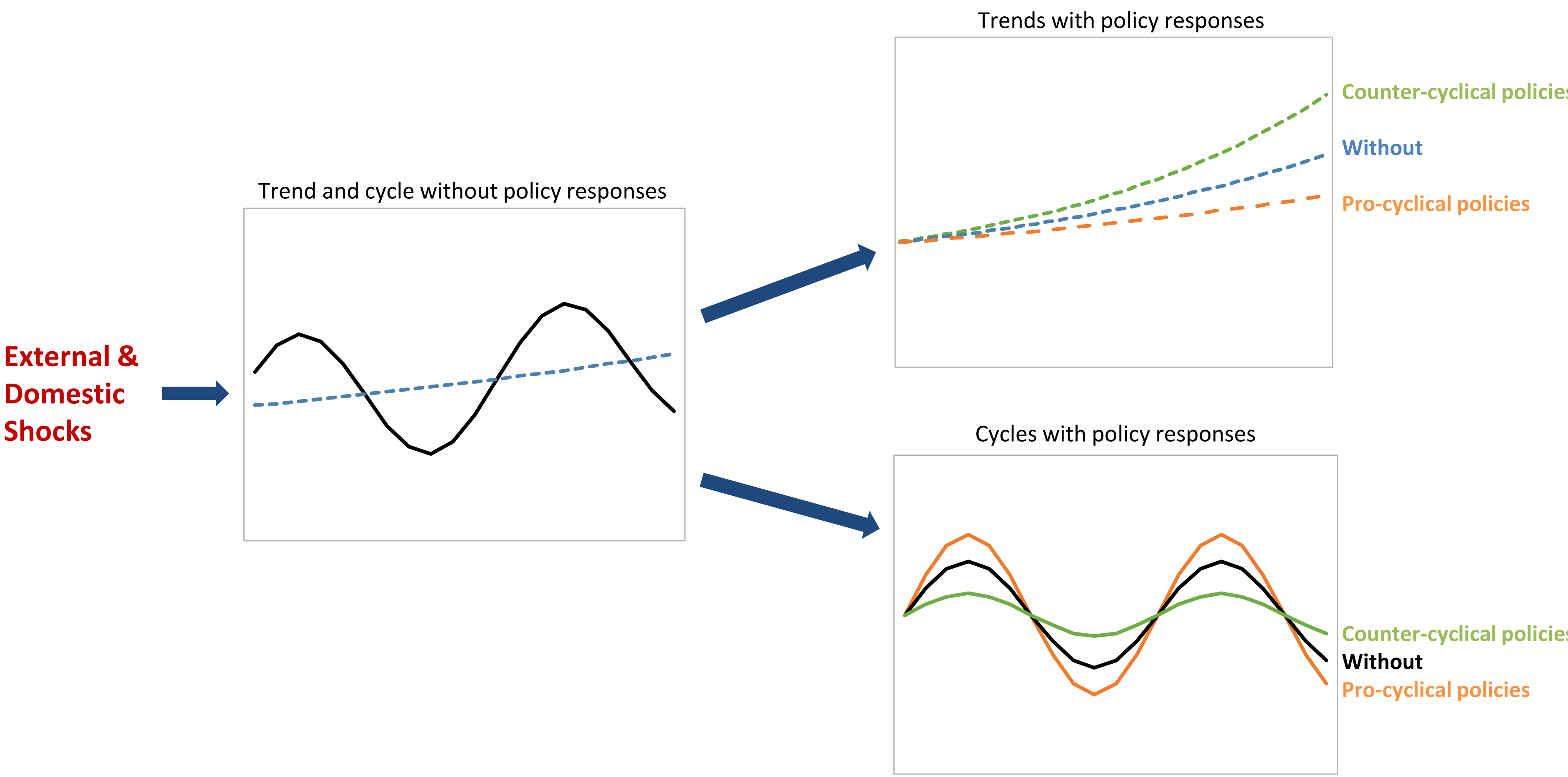
The Case for Counter-Cyclical Macro Policies



But counter-cyclical policies do not happen by accident.

Overview

- Cycles and macro policies: Conventional wisdom
- Output, unemployment, and financial cycles in CAREC economies
- Cyclical behavior of macro policies in CAREC economies: A first pass
  - Monetary policy
  - Fiscal policy
  - Financial sector policies
- Graduating from pro-cyclical to counter-cyclical policies
- Peeling the (counter-cyclical) policy onion

Cycles and Policies: Conventional Wisdom

- Cycles and macro policies in advanced economies (AEs) are different from cycles and macro policies in emerging market (EMs) and low-income countries (LICs):*

  – EM/LIC cycles are bigger than AE cycles; "rule of 2 times"

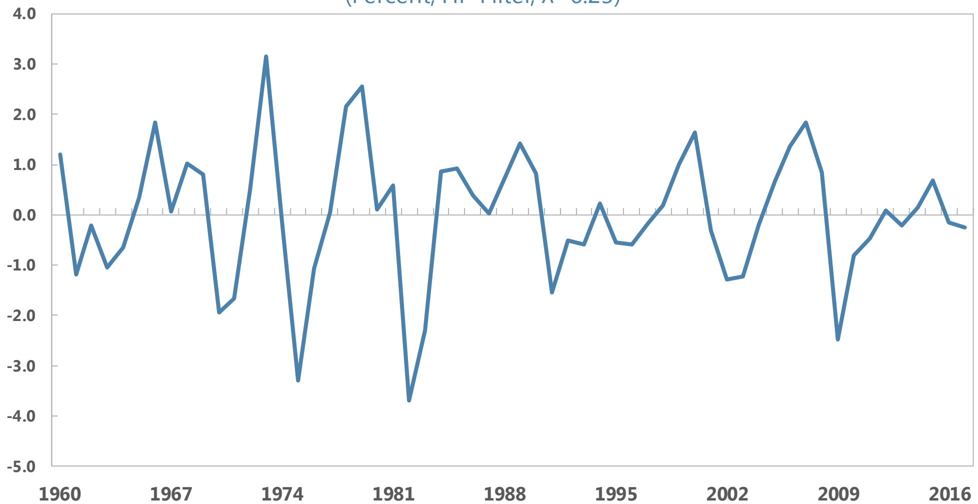
  – EM/LIC cycles are exacerbated by pro-cyclical macro policies; "when it rains it pours"

- But, over the last decade or so, about 1/3 of EMs have graduated from pro-cyclical to more counter-cyclical monetary and fiscal policy frameworks*

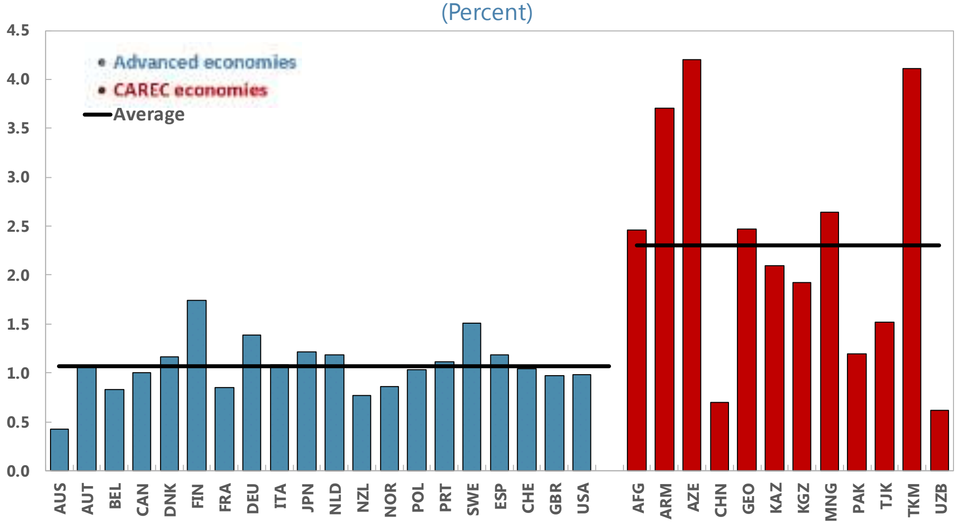
*See references discussing cycles and macro policies in EMs/LICs vs. AEs in slide at end of presentation

Output Cycles

United States: Output Cycle, 1960-2017
(Percent, HP Filter, λ=6.25)

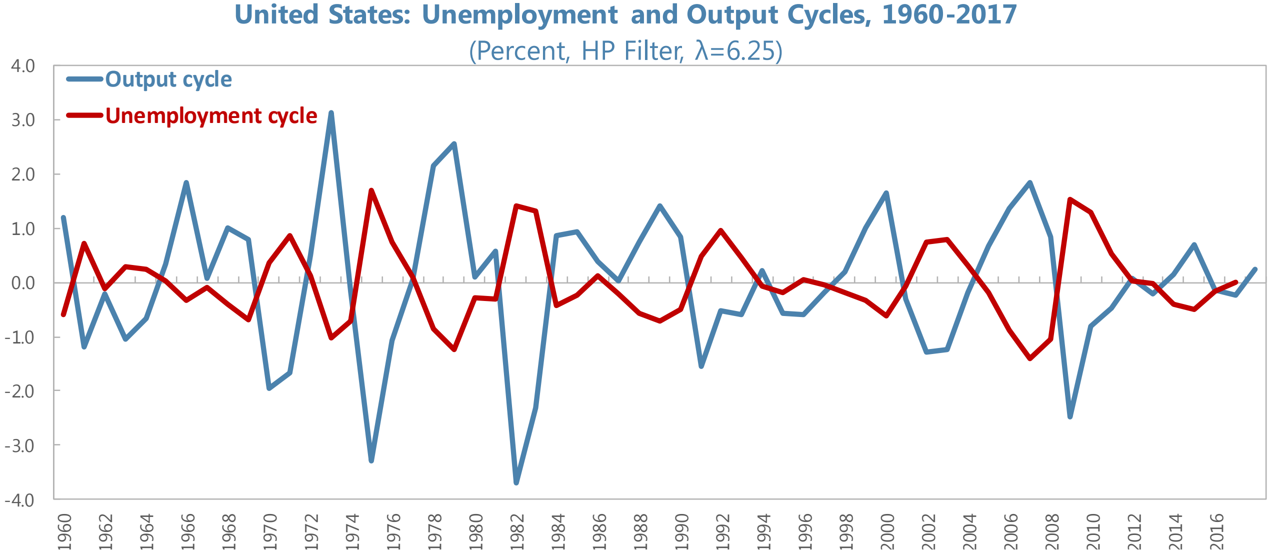


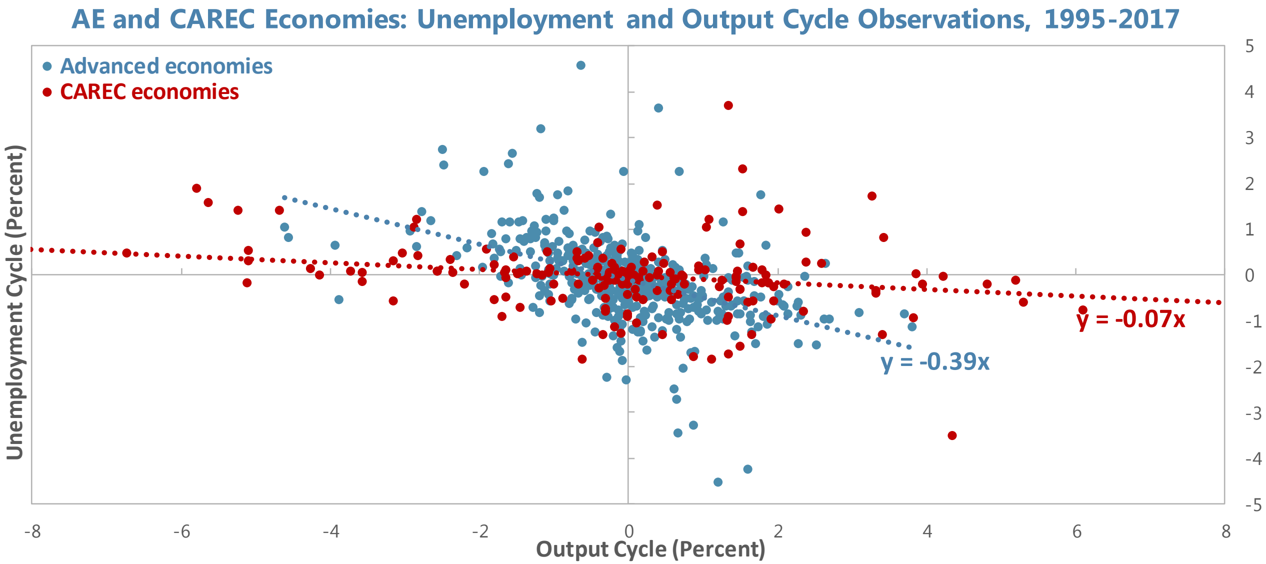
AEs and CAREC Economies: Standard Deviation of Output Cycles, 1995-2017
(Percent)



- Mainstream view of output cycle: Transitory output movements around long-term growth trend
- Spurious cycle caveat: Mechanical detrending can result in artificial cycles (Hodrick-Prescott (HP) filter tailor-made for US output cycles)
- CAREC economies' output cycles twice as large as AE cycles

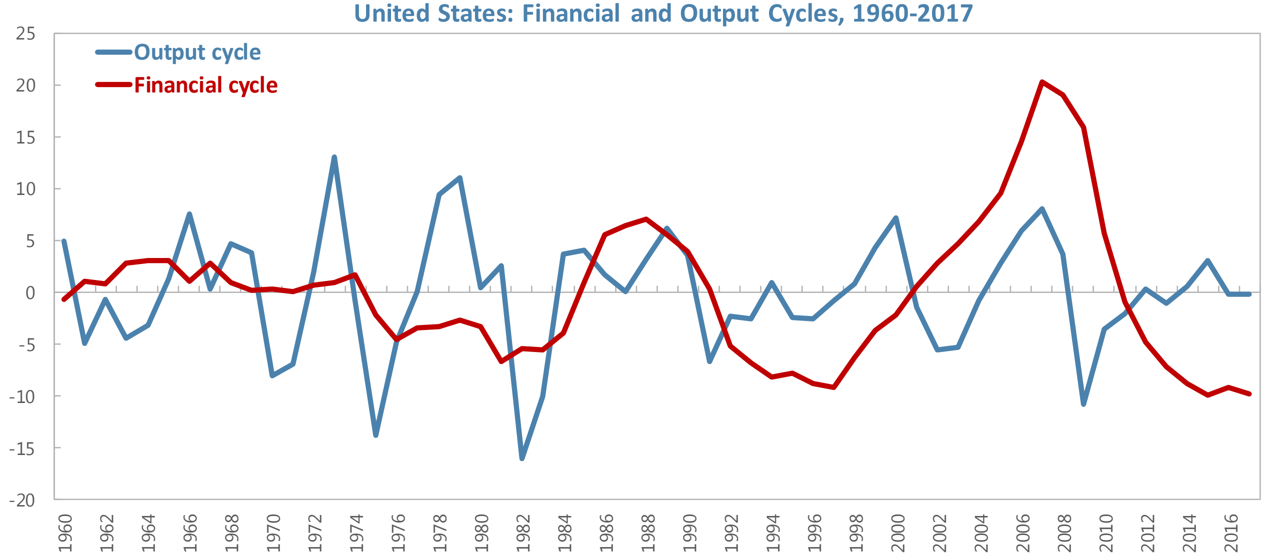
Unemployment and Output Cycles

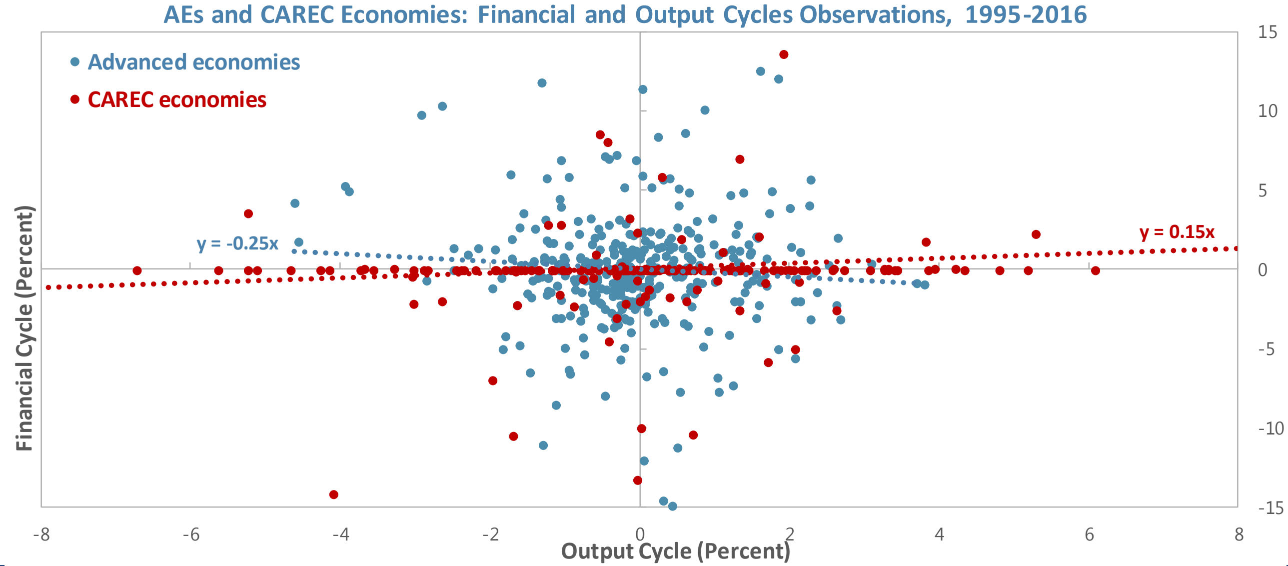




- In AEs, close (inverse) link between output and unemployment cycles (Okun's Law)
  - Stabilizing output <=> stabilizing unemployment
- In CAREC economies: Little link between output and unemployment cycles
- Why is this?
  - Low quality of labor data
  - Size of informal sector

Financial and Output Cycles

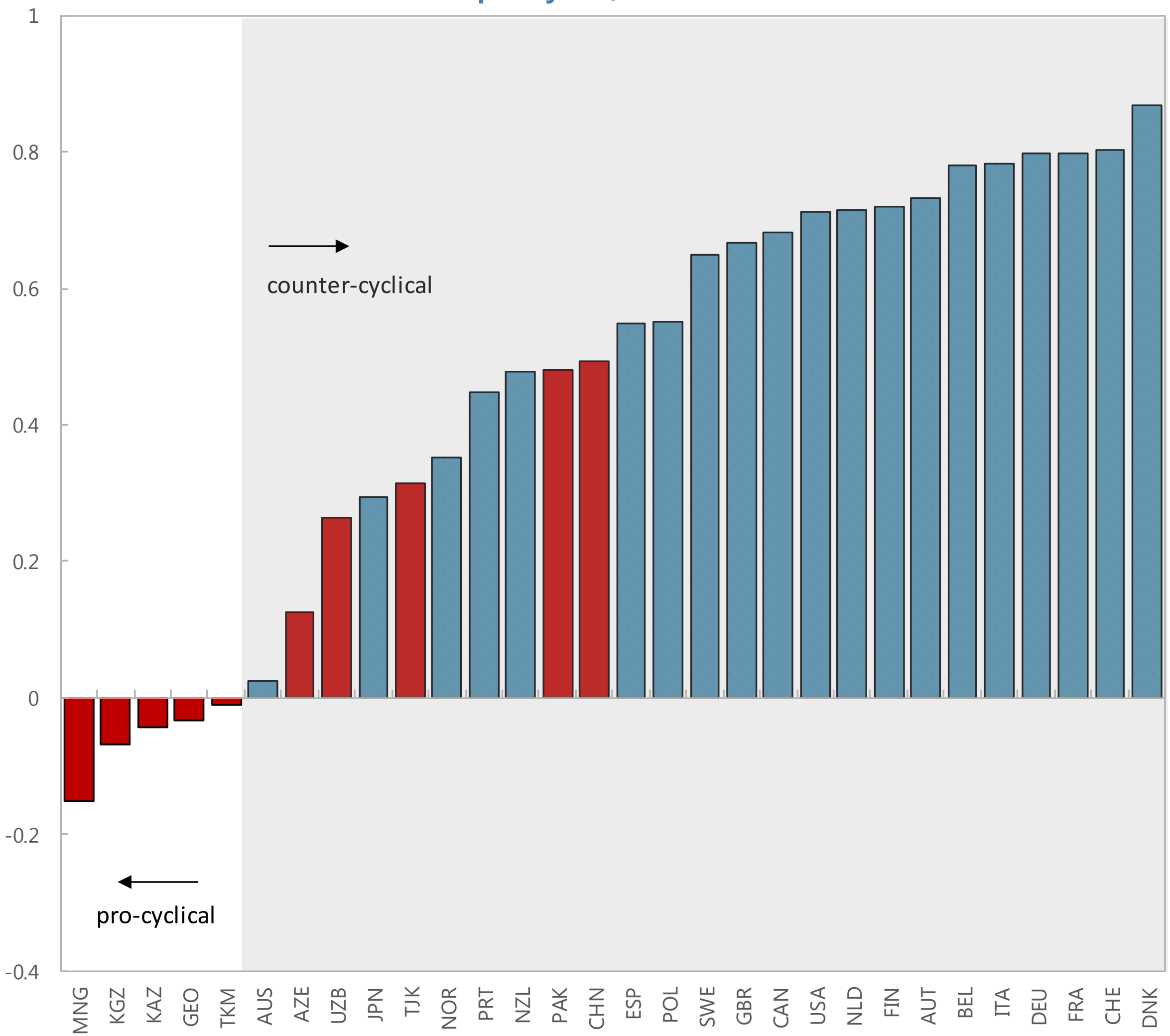




- Financial cycle: An old idea, rediscovered thanks to Global Financial Crisis in 2008-09
- In most countries, financial (credit) cycles tend to be longer/bigger than output cycles
- As a consequence, little correlation between financial and output cycles in both AEs and CAREC economies
- But evidence that financial cycles drive length and amplitude of output cycles, especially during recessions

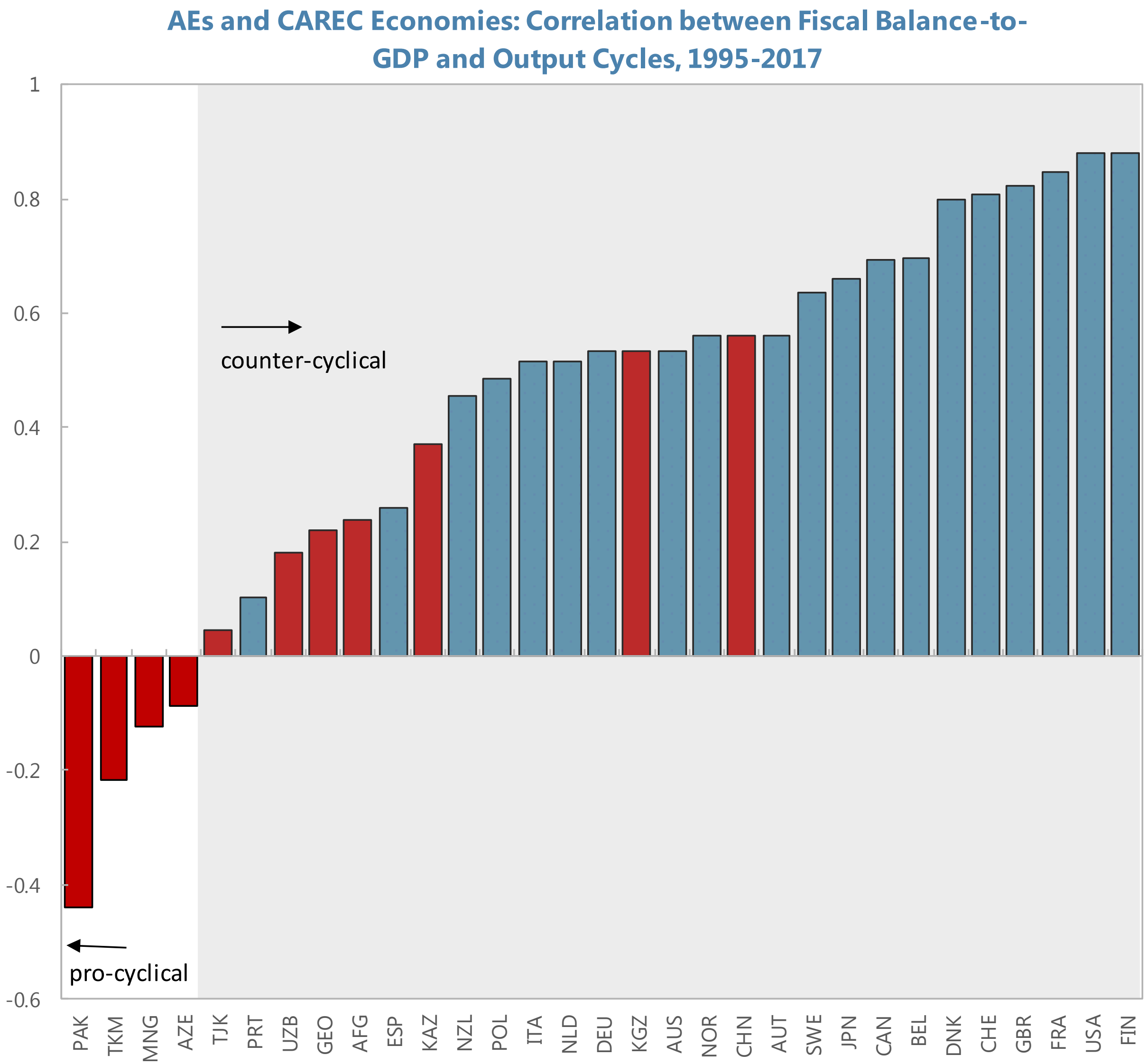
Cyclical Behavior of Monetary Policy

AEs and CAREC Economies: Correlation between Interest Rate and Output Cycles, 1995-2017



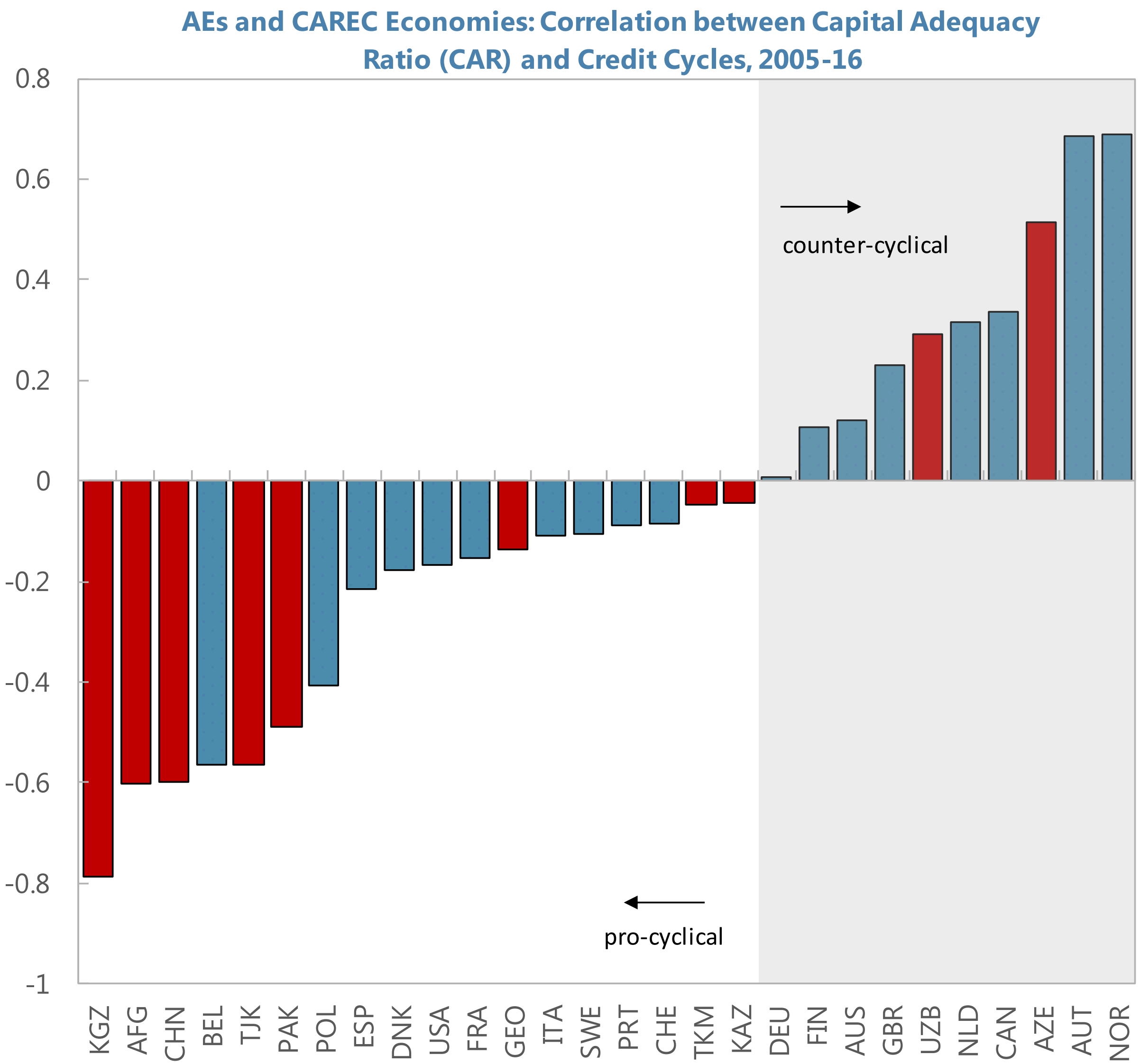
- In AEs, monetary policy generally strongly counter-cyclical
- In CAREC economies, mixed cyclical monetary policy behavior
- Why is this?
  - Liability dollarization
  - Lack of policy credibility
  - Fear of free falling = perceived need to use interest rate to defend exchange rate during cyclical downturns

Cyclical Behavior of Fiscal Policy: Fiscal Balance



- In AEs, fiscal policy was generally counter-cyclical
- In CAREC economies, fiscal policy was mostly neutral but with exceptions
- Why is this?
  - Output expansion phase (good times): Political economy pressures to spend and cut taxes
  - Output contraction phase (bad times): inability to borrow

Cyclical Behavior of Financial Sector Policies

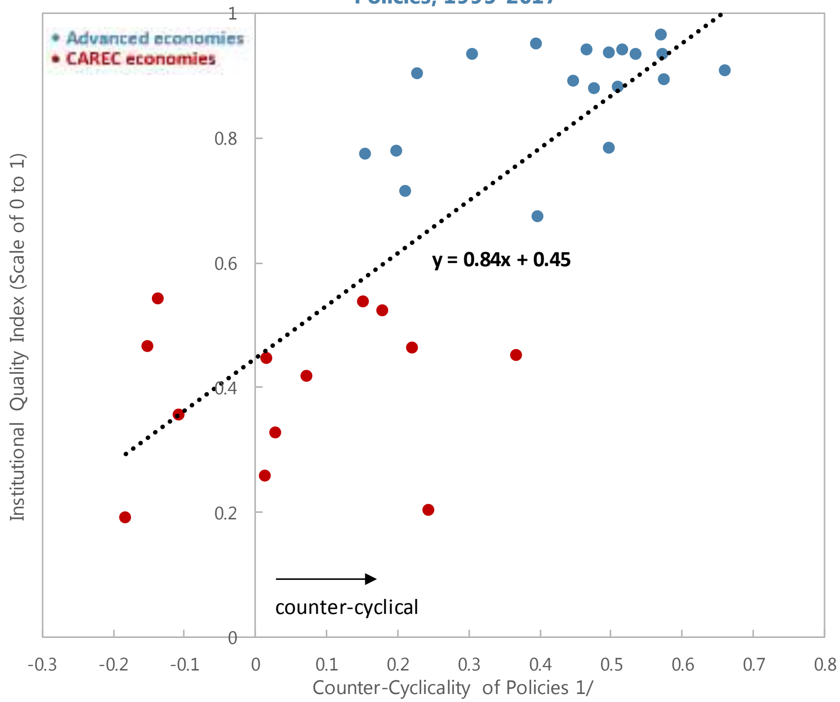


- Many indicators of prudential stance (capital buffers, leverage ratios, provisioning, loan-to-value ratios)
- Capital adequacy ratios (CARs) in most CAREC economies pro-cyclical (with respect to financial cycle)
- Why is this?
  - Data series too short
  - Supervisory frameworks not risk-based
  - Supervisory forbearance

Graduating from Pro- to Counter-Cyclical Policies

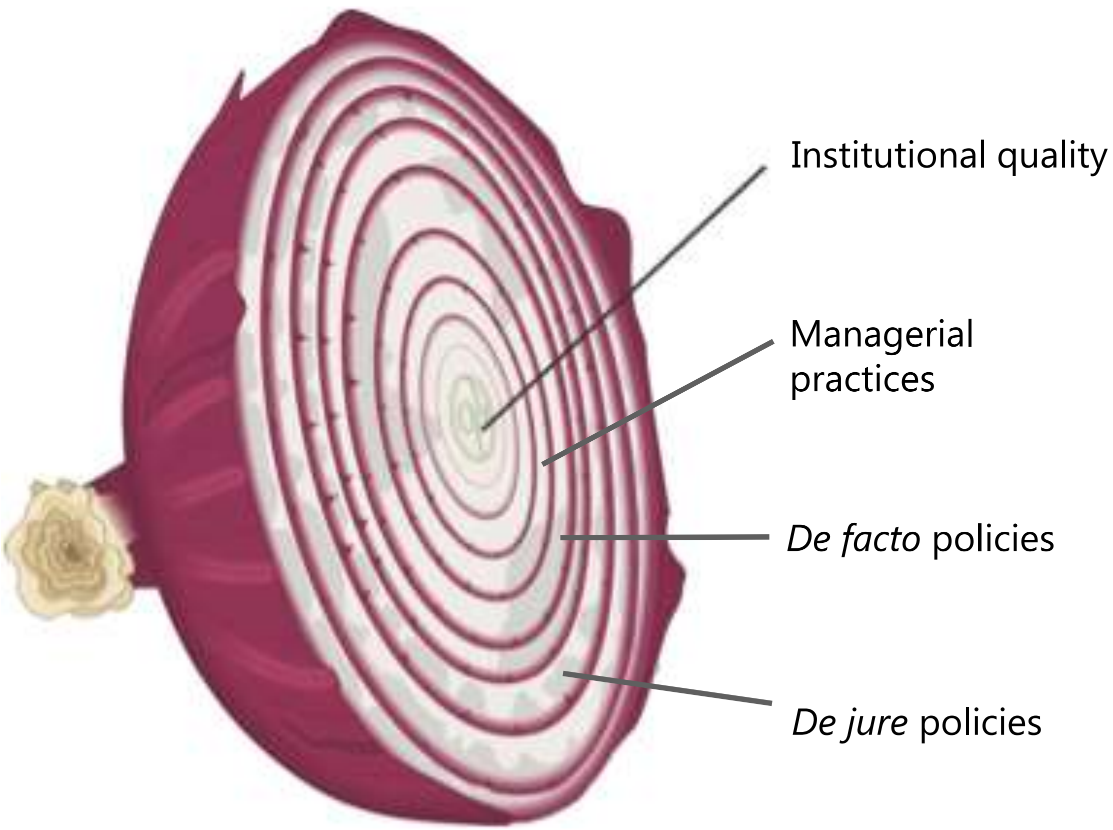
- Promoting counter-cyclical monetary policy
  - Better monetary frameworks (inflation targeting)
  - Financial deepening
- Promoting counter-cyclical fiscal policy
  - Improved fiscal transparency
  - Fiscal rules; stabilization funds
- Promoting counter-cyclical financial sector policies
  - Rules- and risk-based supervision frameworks (Basel III)
  - Improving governance of banks
- Ultimate graduation bottleneck: Institutional quality
  - Rule of law
  - Corruption
- Role for international financial institutions (IFIs) and peer-to-peer learning

AEs and CAREC Economies: Institutional Quality and Cyclicality of Policies, 1995-2017



1/ Simple average of monetary, fiscal, and financial sector policy correlations.

Peeling the (Counter-Cyclical) Policy Onion



- First layer: Policies on paper (*de jure*)
- Second, layer: *De facto* policies reflect implementation capacity
- Third layer: Implementation capacity depends on managerial practices
- Final layer: Managerial practices depend on quality of institutions

Some References

Cycles and Macro Policies: General

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Cycles and Monetary Policies

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- Frankel/Végh/Vuletin (2017), On Graduation from Fiscal Procyclicality

Cycles and Financial Sector Policies

- Borio (2014), The Financial Cycle and Macroeconomics: What Have we Learnt?
- Claessens et.al. (2012), How Do Business and Financial Cycles Interact?

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