Costs of Crises and Policies for Recovery

Valerie Cerra, IMF

Outline

- Types of shocks important for LICs

- Costs of crises and other shocks

- Policies for recovery

- Looking ahead
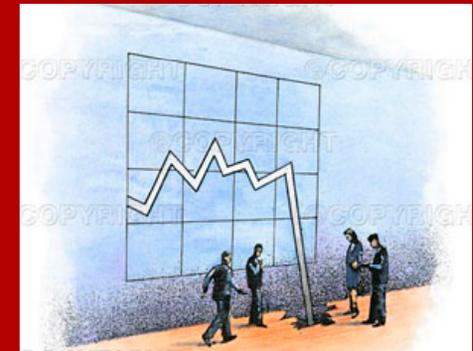
What *are* the shocks?

- Natural disasters
- Trade volatility
  - Prices – terms of trade
  - Quantities – world demand
- World interest rates
- Capital flows
  - Aid
  - Remittances
  - FDI
- Financial crises
- Political crises
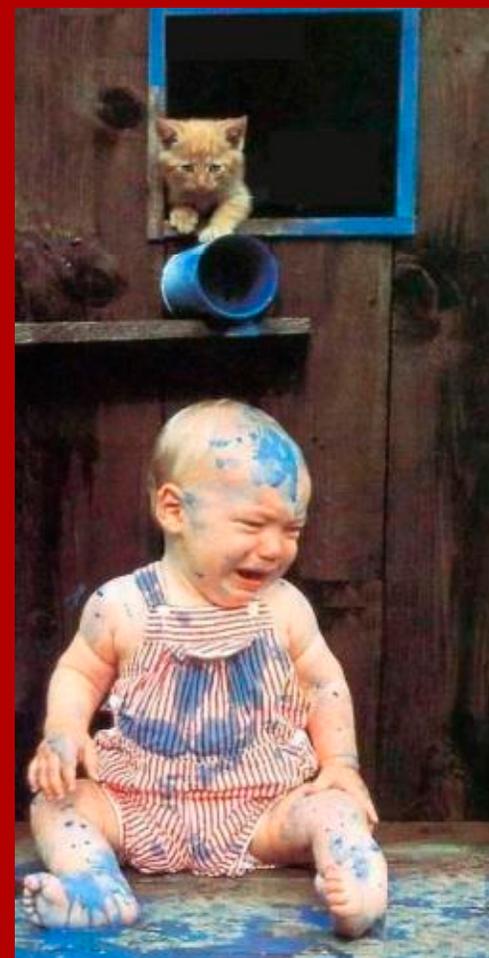
Frequency of natural disasters

Number of natural disasters by country: 1976-2005
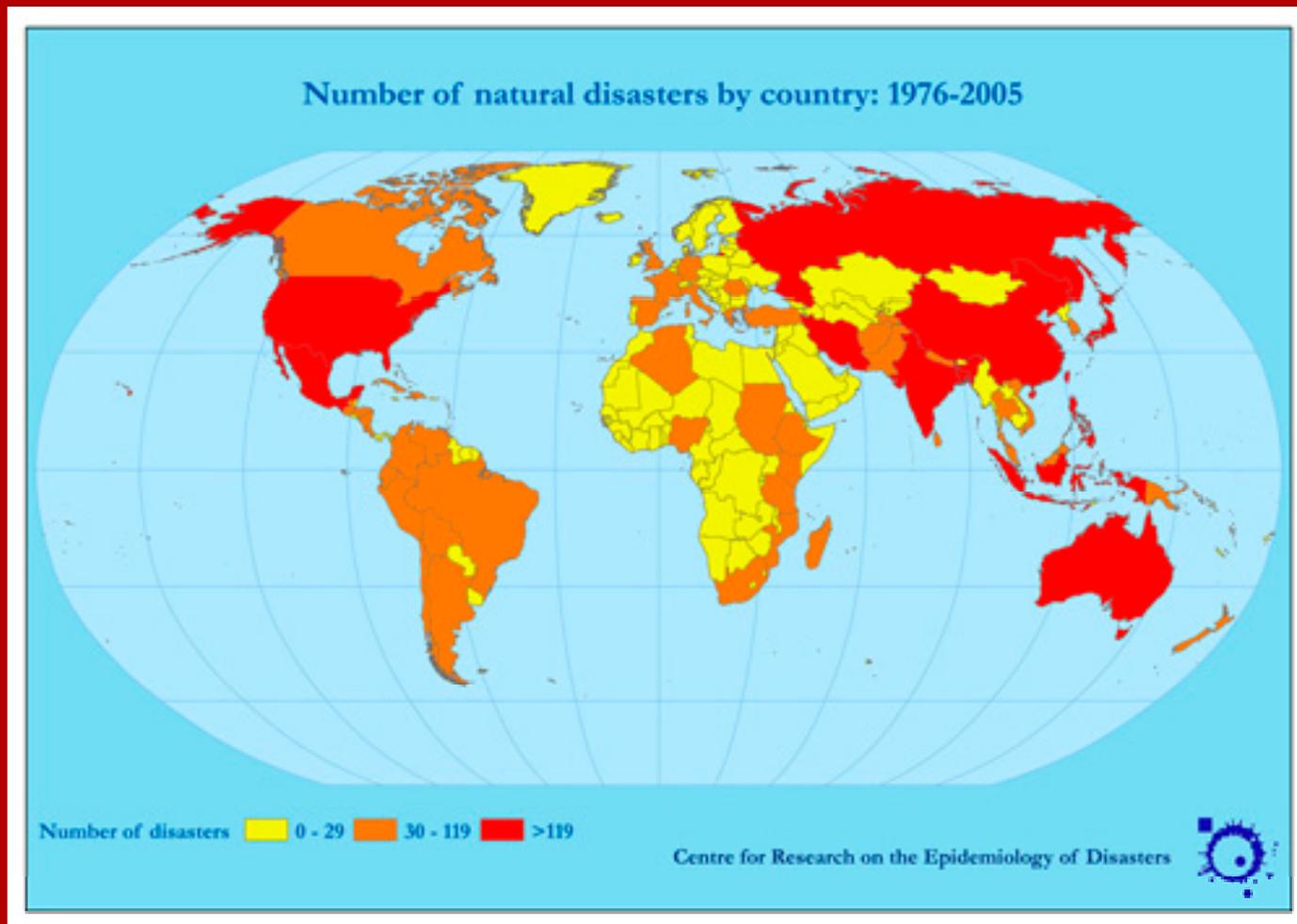
Impact of natural disasters: victims
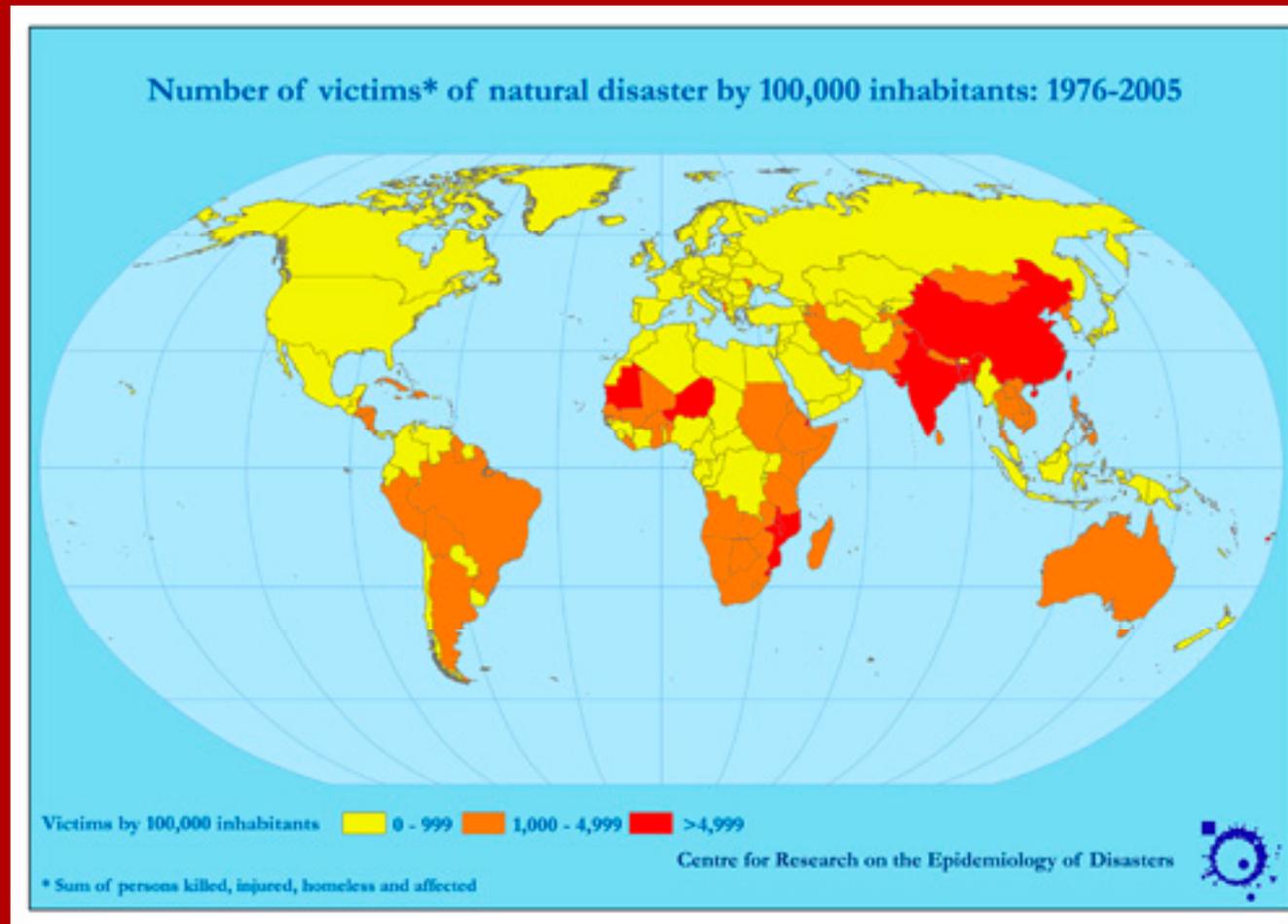
Frequency of crises

| | All available years | | | | 1992–2001 | | | |
| | Financial crises | | Political crises | | Financial crises | | Political crises | |
	Currency	Bank	War	Constraints	Currency	Bank	War	Constraints
Africa	37	4	12	6	34	4	16	23
Asia	23	3	16	7	19	4	10	9
Industrial countries	22	2	1	1	28	1	4	1
Latin America	31	5	10	5	27	5	10	8
Middle East	26	4	10	4	16	2	5	12
Transition countries	27	6	6	4	20	6	11	13
Western Hem. islands	21	2	0	3	11	5	0	3
High income	20	2	0	2	20	1	0	0
Upper middle income	23	5	2	3	16	4	0	8
Low middle income	30	5	10	6	26	6	13	12
Low income	36	4	18	6	32	4	19	23

Wars, Crises, and Regime Change Oh My!

Percent of Recession Years Coinciding with Shock

|	LICs	Other Inc groups
Currency Crisis	43	34
Banking Crisis	27	25
Rise in Unconstrained Executive Power	8	7
Civil War	22	7
Any of Above	68	60

Costs of crises
-Financial
-Political

- Based on work in Cerra and Saxena, "Growth Dynamics: The Myth of Economic Recovery" AER, March 2008

Empirical specification

$$g_{it} = a_i + \sum_{j=1}^{4} \beta_j g_{i,t-j} + \sum_{s=0}^{4} \delta_s D_{i,t-s} + \varepsilon_{it},$$

Business
cycle
dynamics

Indicator
of
crisis

# *On average*, financial crises generate persistent output loss
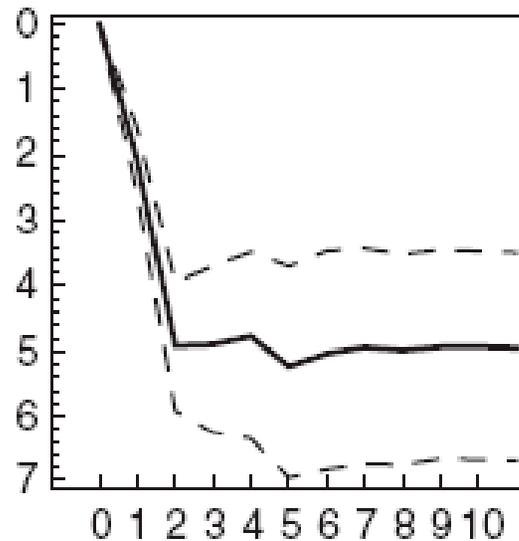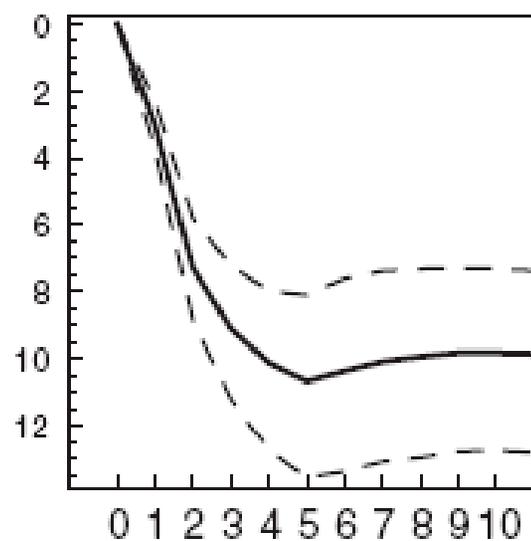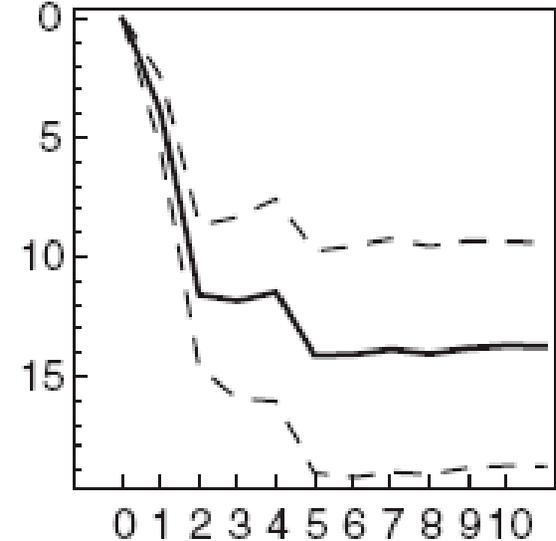
On average, political crises also generate persistent output loss
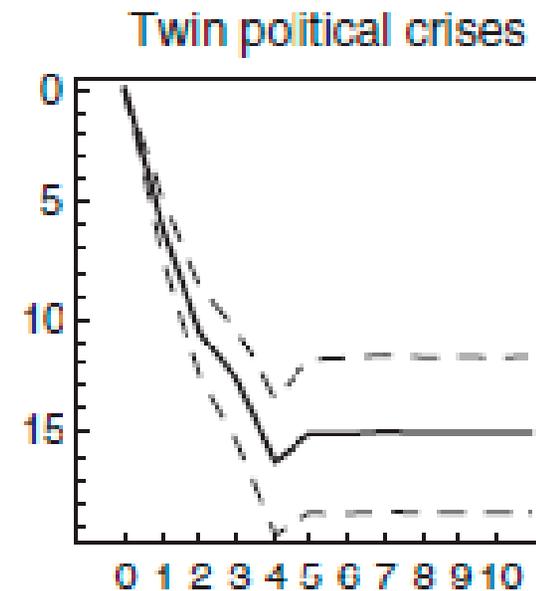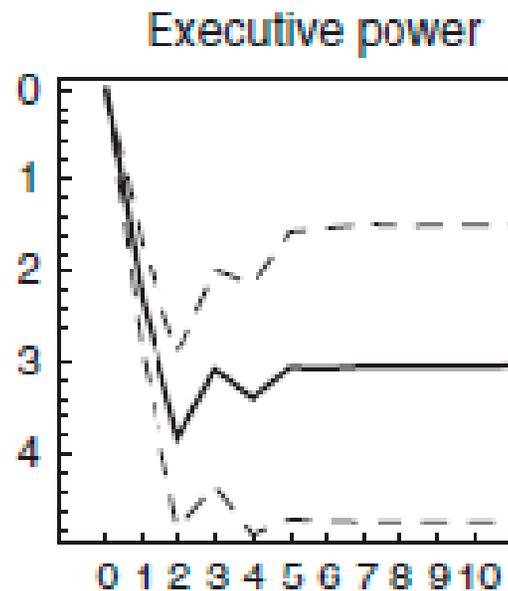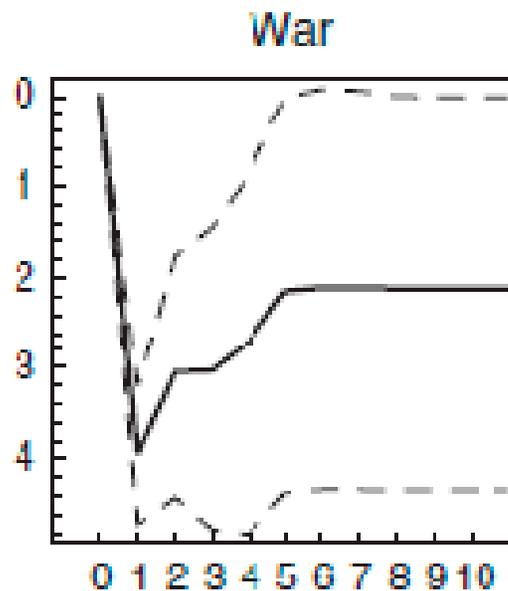
Currency crises have larger impact at lower income levels

FIGURE 3. IMPULSE RESPONSES: CURRENCY CRISES
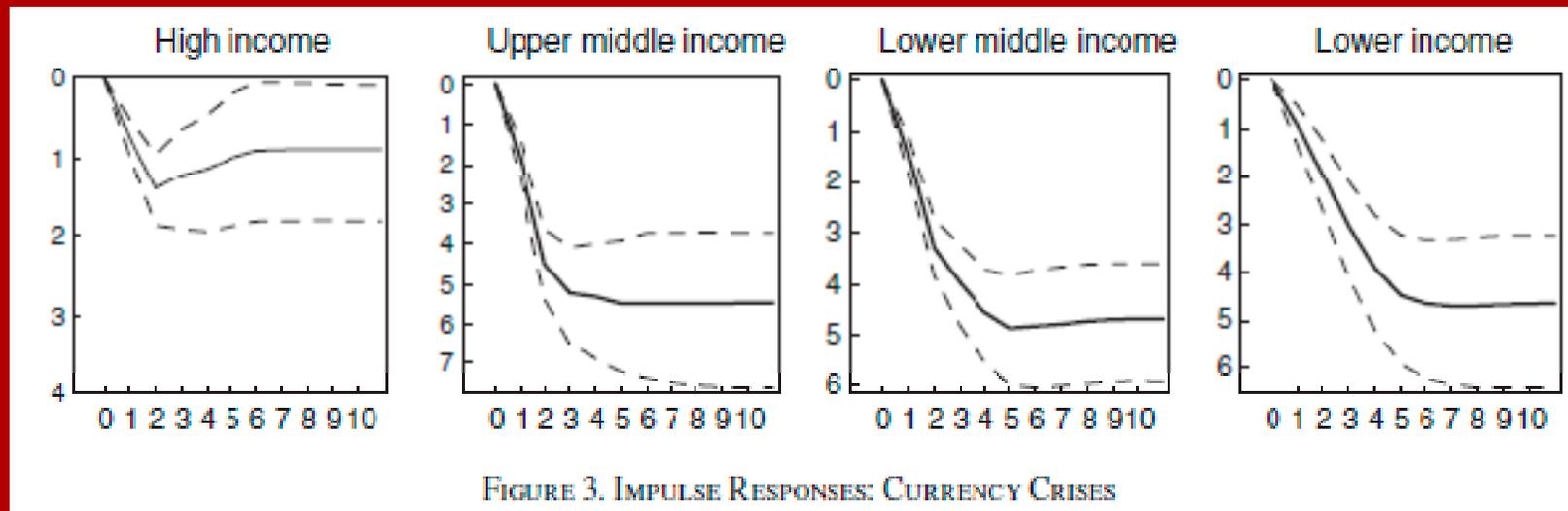
Increase in executive power: impact depends on income level

FIGURE 7. IMPULSE RESPONSES: STRONGER EXECUTIVE POWER
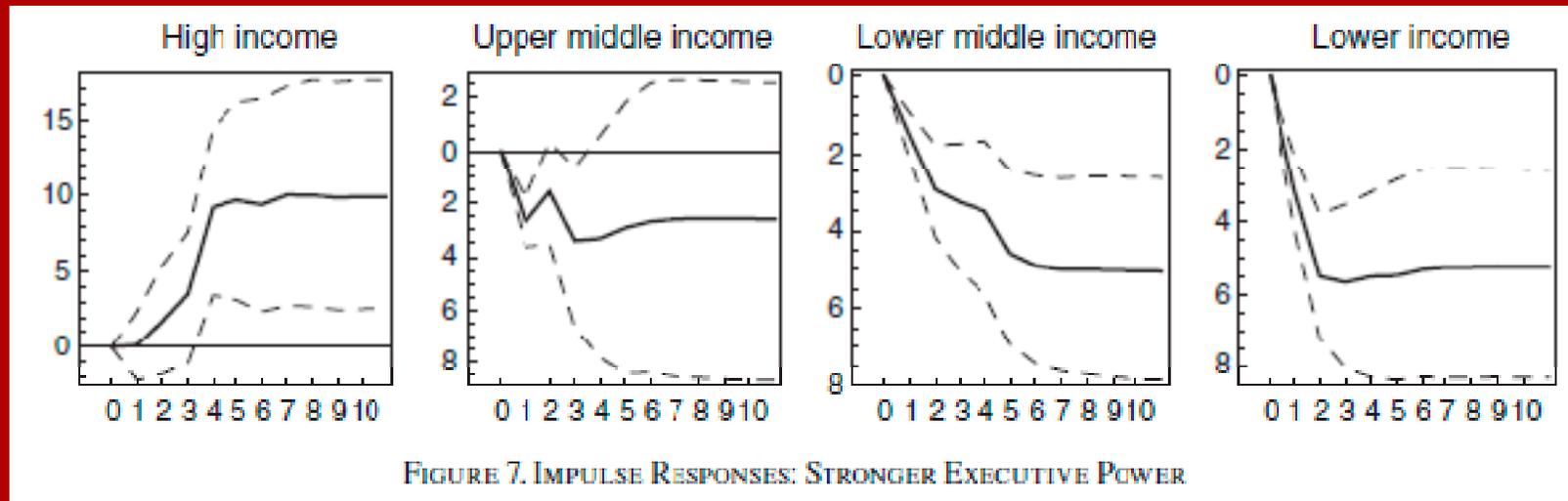
Typical recession and recovery
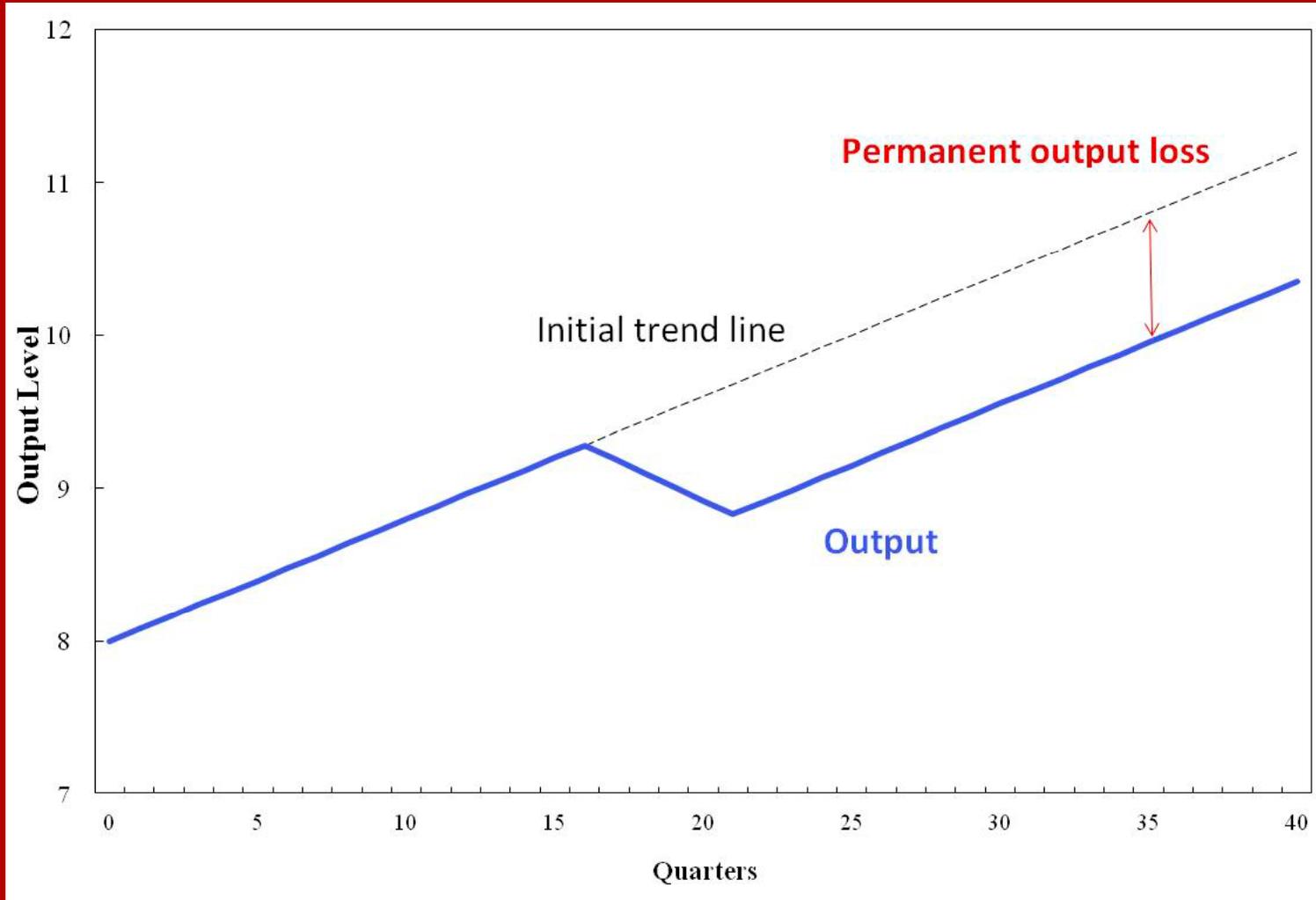
Policy implications:
Potential output & Output gap

- Lower level of economic activity
  - Welfare loss
  - Higher debt ratios (denominator effect)
  - Lower level of revenue
- Monetary policy reaction to output gap
- Perhaps different concepts of output gap for fiscal and monetary purposes
  - Trend
  - Inflation pressure

Does vulnerability to negative shocks set you back?

- Country long run growth rates may differ

- Higher returns for higher risks?

Down and Out

|	Average growth rate
Volatility (proportion of years in recession)	-12.7 ***
T-stat	-9.9
Adjusted R-squared	0.42

Divergence

- **Are contractions partly responsible for absolute divergence?**

- **Would poor countries catch up to the rich if not for the bad shocks?**

Divergence big time: It's the crises

Dependent Variable:	Average Growth Rate 1960-2000			
	All years	Expansion years only	Recession years only	Proportion of of recession years
ln RGDP per capita in 1960	0.30 **	-1.02 ***	1.04 ***	-0.085 ***
T-stat	2.2	-5.2	5.8	-6.4
Adjusted R-squared	0.02	0.16	0.15	0.20
No. of Countries	112	112	112	112

# Convergence in expansions, Divergence in recessions
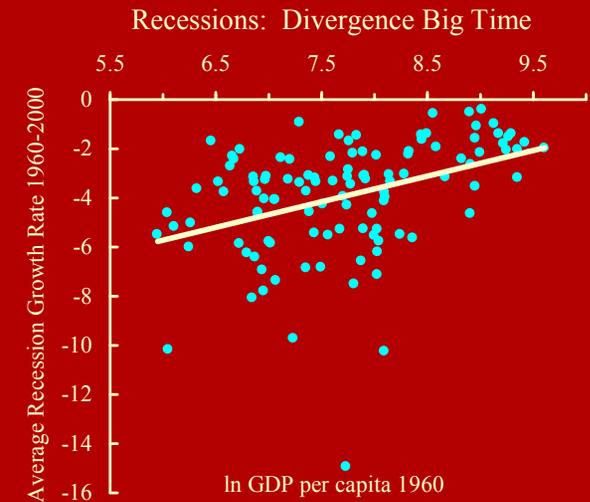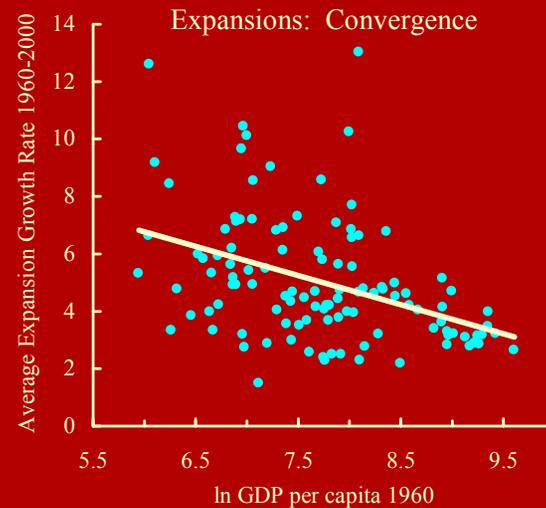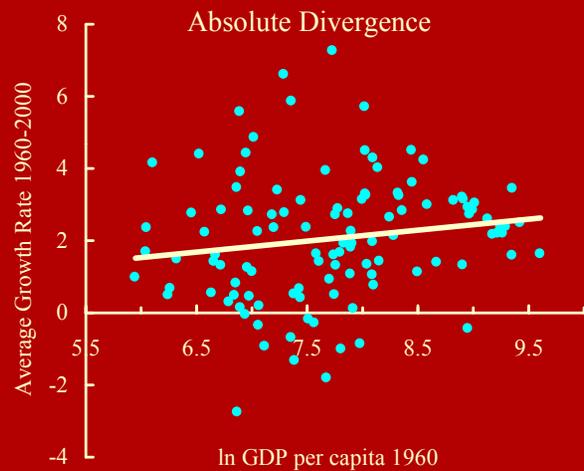
Source: Cerra and Saxena, "Growth Dynamics: The Myth of Economic Recovery"
 **(IMF WP 05/147)**

Stylized Model of Development
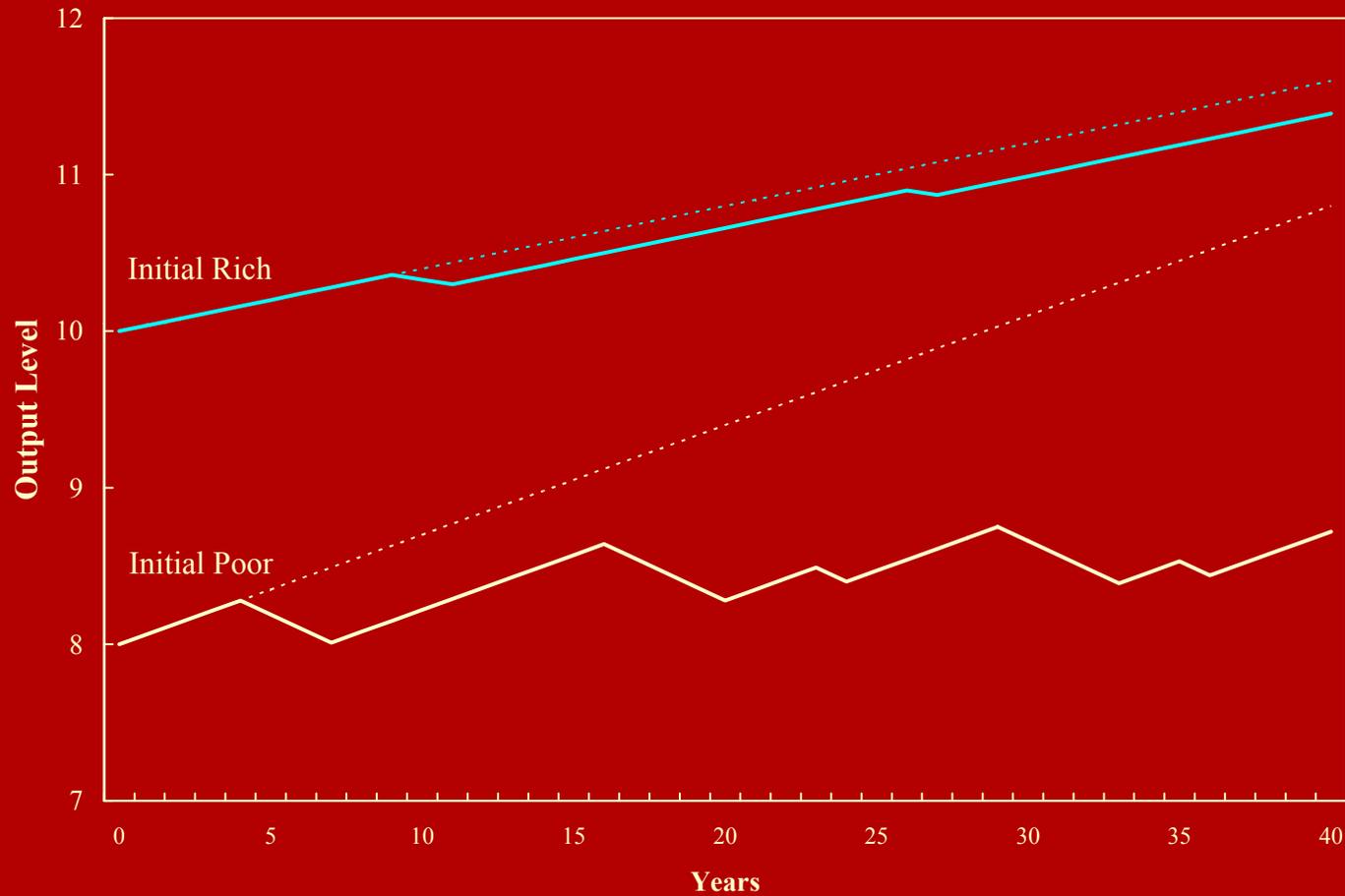
Source: Cerra and Saxena, "Growth Dynamics: The Myth of Economic Recovery"
(IMF WP 05/147)

# Diversity of experience within the average
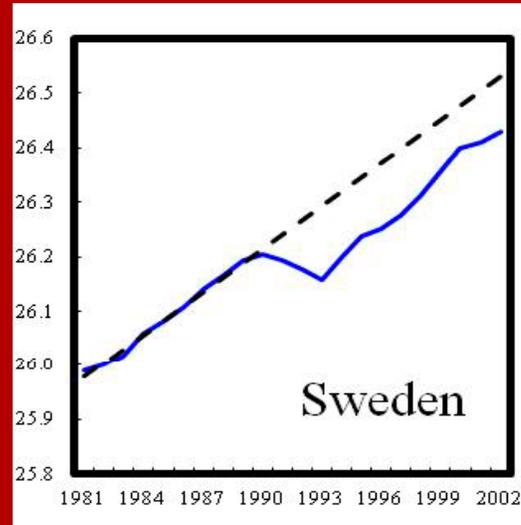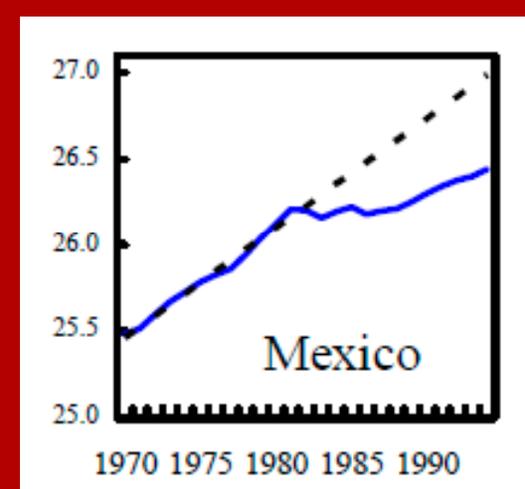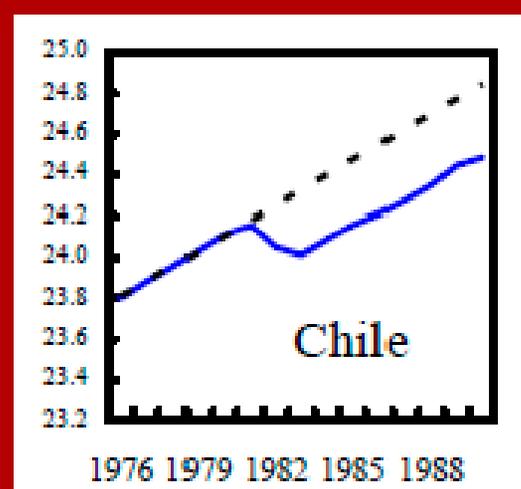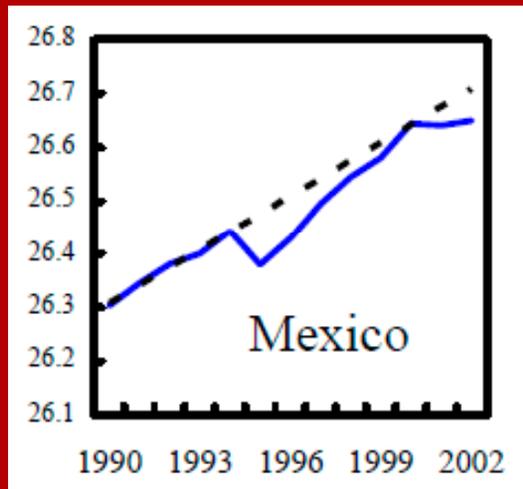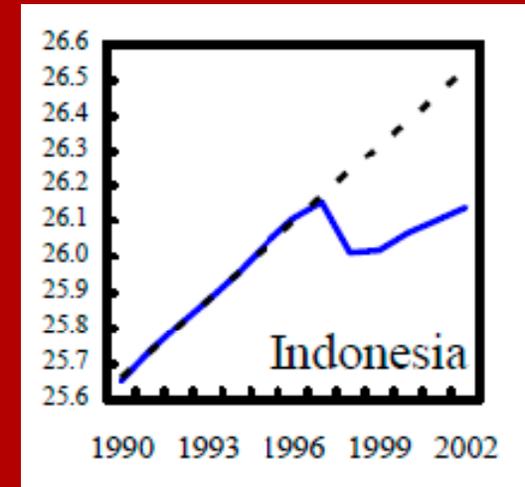
Policies for Recovery

Different recovery profiles
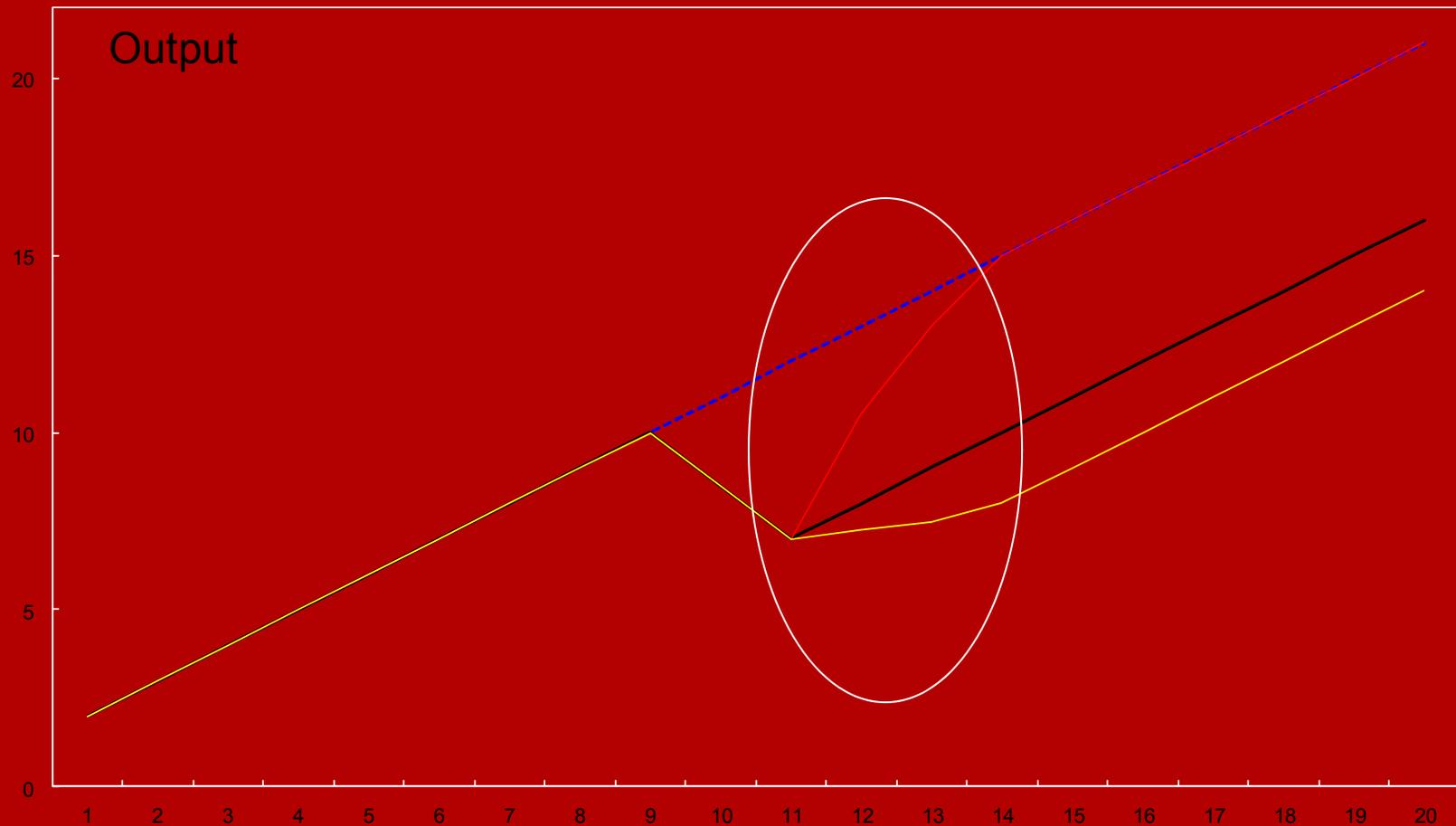
Fiscal policy

	IND	DEV	DEV NO SSA
Recovery Year (RY)	-0.60 *	-0.75 **	-1.39 ***
Fiscal deficit ratio to GDP	n.s.	n.s.	n.s.
RY * Deficit ratio	0.12 **	n.s.	0.11 **

Monetary policy

	IND	DEV	DEV NO SSA
Recovery Year (RY)	-0.71 **	-1.23 *	-1.19 *
Real money growth	n.s.	0.06 ***	0.06 ***
RY * Real money growth	0.13 **	n.s.	n.s.

Foreign Aid

	DEV	DEV NO SSA	SSA
Recovery Year (RY)	n.s.	-1.3 ***	n.s.
Aid growth	n.s.	n.s.	n.s.
RY * Aid growth	2.5 *	n.s.	4.9 **

Exchange rate regime (fix & intm)

	IND	DEV	DEV NO SSA
Recovery Year (RY)	n.s.	n.s.	n.s.
Interm ex rt regime	n.s.	n.s.	n.s.
Fixed ex rt regime	n.s.	0.7 **	0.8 **
RY * Interm	n.s.	-1.6 **	-1.7 **
RY * Fix	-1.5 **	n.s.	-1.3 **

Real exchange rate

	IND	DEV	DEV NO SSA
Recovery Year (RY)	-0.9 ***	n.s.	-0.8 **
RER (relative to US dollar)	n.s.	1.8 ***	1.8 *
RY * RER	n.s.	-3.2 **	n.s.

Looking ahead:
What do we need to learn?

- **Output gap – implication for fiscal & monetary policy**

- **Direction of causality and common factors**

- **Policies and conditions fostering resilience: this crisis as experiment**
  - **Macroeconomic stimulus**
  - **Buffers (high reserves, low debt, social safety nets)**
  - **Financial development**
  - **Trade and financial integration**

Conclusions

- Different responses to shocks
- Financial crises and many political crises have permanent impact on level of output
- Crises derail growth for LICs, incomes diverge: crisis traps
- Macro policies can boost recovery
  - sometimes with greater effectiveness than in later stages of expansion

Thank You