# Strengthening economic resilience: What lessons to draw from the post-1970s record of severe recessions and financial crises

By Alain de Serres, Filippo Gori and Mikkel Hermansen, OECD Economics Department

Major global crises such as the 2008-09 episode are mercifully rare, but severe recessions have been quite frequent among OECD countries over the past four decades. Even when they do not inflict long-lasting economic damages, they often entail significant costs in terms of foregone income and high unemployment. It is therefore important that measures be taken to minimise the risk and frequency of such episodes, but also to mitigate their impact once they occur. This raises the question of what can policy makers do to lastingly enhance resilience in the face of economic and financial risks. In looking for answers, they need to be mindful of the potential long-term growth impact of risk-mitigating measures.

More specifically, in considering measures to reduce risks, the benefits need to be balanced against the potential costs in terms of the lower average economic growth rate that some policies could entail. The objective is to reduce financial fragilities and minimise systemic risk, but without undermining entrepreneurial risk-taking, which is the essence of innovation-based economic growth. When risk-mitigating measures involve a trade-off between growth and crisis risk, the most cost-effective actions need to be identified, spanning both macro and structural policies.

Recent OECD research sheds light on possible growth-crisis trade-offs from two angles: i) looking at the extent to which pro-growth policies can make economies more vulnerable to severe recessions and ii) assessing the impact on growth of risk-mitigating (prudential) policies. These issues are explored using an empirical approach that provide insights on both the impact of various policy settings on average GDP growth on the one hand, and either financial crises (i.e. banking, currency and twin crises) or exceptionally low GDP growth rates (i.e. extreme negative tail risk), on the other (see references).

**What are the main insights from this research?** Considering first policies outside the financial sector, that is product and labour market policies as well as those related to the quality of institutions, there is no evidence that policymakers would face trade-offs between enhancing growth and reducing risks of crises (see figure).

- The results indicate having in place a sound legal and judicial infrastructure – based on a high quality of institutions – is good for both growth and resilience. It may do so notably by facilitating a greater diversification of funding sources away from the banking sector and towards capital markets.
- Regarding product and labour market policies, the findings indicate that policy settings conducive to higher productivity (*g*. through stronger product market competition) and employment generally have little impact on crises risks, *i.e*. they do not reduce the likelihood of severe recessions, but do not raise it either.

More significant trade-offs between growth and crisis risks arise in the case of financial market policies:

- Financial market liberalisation often yields stronger growth, but also higher risks of banking crises and hence severe recessions. That said, in the cases where liberalisation essentially leads to the development of private credit – in particular bank credit – as opposed to equity-based financial instruments, the impact on growth diminishes.

- Greater capital flow openness raises growth, but also increases the risk of banking and currency crises. However, the results indicate that among the different types of capital flows, only debt is associated with higher crisis risk.
- The risk of crises can be mitigated through prudential policies. Indeed, greater use of prudential policies is associated with fewer occurrences of severe recessions. At the same time, the findings indicate that several of these measures may come at a cost in terms of lower average growth.


***Note:* Structural policies should be assessed on the basis of their effect on growth and economic fragility. In this chart, the effect of policies on economic fragility is plotted on the horizontal axis, the effect on growth is shown on the vertical**

**axis. Fragility is defined as a higher likelihood of financial crises (banking, currency or twin crisis) or a higher GDP (negative) tail risk. Different risk-growth patterns emerge for each of policy area considered: pro-growth labour and product market policies improve economic performance without substantially affecting economic fragility. Better quality of institutions both increases growth and reduces economic fragility. However, macro-prudential and financial market polices entail a growth-risk trade-off: the former decrease economic risk to the detriment of a higher growth rate, the latter promote growth but also increase financial risk.**
***Source*: Authors' calculation based on Caldera Sánchez and Gori (2016) and by Caldera Sánchez and Röhn (2016).**

**What does this mean for policy?** One of the main implications of the analysis is that taking measures in the financial sector to lower the risk of severe recessions is entirely appropriate, but focusing too narrowly on that sector is unlikely to be sufficient and could entail substantial costs in terms of foregone GDP growth.  Policymakers need to consider other potential sources of distortions that can contribute to the build-up of vulnerabilities.

OECD research also shows that among the factors creating an environment prone to severe recessions, the more prominent are rapid growth of private credit, imbalances in the housing market (as proxied by real house prices and the ratios of house prices to income and house prices to rent), and, to a lesser extent, large current account imbalances. This points to the need for looking at how domestic policy distortions – notably in the areas of housing market regulation as well as taxation – contribute to excess leverage, in particular through real estate markets and current account imbalances.

## References:

Caldera Sánchez, A., A. de Serres, F. Gori, M. Hermansen and O. Röhn (2016) “Strengthening economic resilience: insights from the post-1970 record of severe recessions and financial crises economic policy paper", *OECD Economic Policy Papers*, December 2016 No. 20.

Caldera-Sánchez, A. and O. Röhn (2016), "How Do Policies Influence GDP Tail Risks?", *OECD Economics Department Working Papers,* No. 1339, OECD Publishing, Paris.

Caldera-Sánchez , A. and F. Gori (2016), "Can Reforms Promoting Growth Increase Financial Fragility? An Empirical Assessment", *OECD Economics Department Working Papers,* No. 1340, OECD Publishing, Paris.