Policy makers in the advanced economies at the core of the global financial crisis can make the claim that they prevented a new “Great Depression”. However, recovery since the outbreak of the crisis more than five years ago has been sluggish and feeble. These macroeconomic outcomes have to some extent been shaped by the policy mix predominantly adopted in those economies in response to the crisis, one in which very loose monetary policies have been combined with tight fiscal policies.

**Actual GDP has lagged behind its potential along the recovery**

The ongoing recovery in advanced economies has been sluggish and fragile when compared to the three previous ones (Kose et al, 2013) (http://www.voxeu.org/article/why-global-recovery-different). While real GDP per capita returned to positive trajectories soon after previous temporary downturns, this time it not only started decelerating well prior to the global recession year (2009), but has not yet fully recovered its peak levels.

Chart 1 – from Davies (2013) (http://blogs.ft.com/gavyndavies/2013/12/15/can-the-bull-market-last-another-year/) – depicts several key features of the ongoing recovery in the group formed by the US, Euro Area, Japan and UK. First, the aggregate growth trend exhibited prior to the crisis is no longer there, either because it was not really sustainable in the long run and/or as a legacy of the crisis. Second, a new “Great Depression” has been avoided but actual GDP has remained subpar relative to the latest IMF/OECD estimates for potential output. Finally, despite the possibility of catching-up with potential GDP in two years, as outlined in the central GDP projection, such an outcome remains subject to policymakers properly calibrating their responses to a wide range of idiosyncratic challenges ahead (Canuto, 2014 (http://www.huffingtonpost.com/otaviano-canuto/calibrating-2014_b_4531942.html)).

Chart 1
At first glance, this is not surprising, given the nature of the factors underlying the crisis: the pervasiveness and magnitude of asset booms and busts; design flaws of the Eurozone fully revealed as the crisis unfolded; the degree of synchronization of recessions; policy uncertainty associated with a loss of confidence on the sufficiency of established policy blueprints; and so on. Moreover, any such transition from a previously booming economy to a “new normal” would necessarily entail a significant reallocation of resources, with creation/destruction of jobs and productive assets. As remarked by Rajan (2013) (http://www.project-syndicate.org/commentary/boosting-demand-impedes-recovery-by-raghuram-rajan#eLCLMXJv2AwggP7F.99):

“(…) the bust that follows years of a debt-fueled boom leaves behind an economy that supplies too much of the wrong kind of good relative to the changed demand. Unlike a normal cyclical recession, in which demand falls across the board and recovery requires merely rehiring laid-off workers to resume their old jobs, economic recovery following a lending bust typically requires workers to move across industries and to new locations.”

On the other hand, gauging by the size and persistence of the gap between actual and potential GDPS exhibited in Chart 1, one may question whether such a transition might have been made faster with appropriate macroeconomic policies. After all, while economists often assume that, no matter where
potential GDP might be, actual GDP will eventually move to it, convergence can occur in the reverse direction. Losses associated with prolonged periods of significant output gaps – e.g., labor de-skilling, foregone R&D efforts, and resource idleness – then become permanent.

The crisis response has been single-handedly based on monetary policy

Kose et al (2013) point out how the recovery in advanced economies may have reflected peculiarities of the policy mix adopted as responses to the recent economic downturn, as compared to previous experiences. While both fiscal and monetary policies have been implemented in a countercyclical direction in the past, that has not been the case this time.

Monetary policy has been extremely accommodative. As policy interest rates approached the bottom – the lower zero bound – central banks went so far as to expand their balance sheets, in conjunction with other unconventional monetary policies (Canuto, 2013). Chart 2 illustrates that by matching short-term interest rates during previous and current (the “Great Recession”) experiences.

Conversely, while previous recovery experiences were supported by the expansion of public spending, fiscal policy has this time moved in the opposite direction (Chart 3). The fiscal stimulus implemented in the US at the outset of the downturn was reversed not long after, followed by fiscal contraction. In the Eurozone, in turn, fiscal austerity policies were implemented as financial havoc morphed into fiscal unsustainability of its crisis-ridden members. Austerity has also been favored in the UK.

Chart 2: Short-term interest rate during global recessions and recoveries (percent)
Note: Zero is the time of the global recession year. Each line shows the PPP-weighted average of the countries in the respective group.


Chart 3: Real primary expenditure (index, PPP weighted)

Notes: Dashed lines denote WEO forecasts. Figures are indexed to 100 in the year before global recession. Zero is the time of the global recession year. Each line shows the PPP-weighted average of the countries in the respective group.


Why has the fiscal and monetary policy mix been so different? On the fiscal policy side, as shown by Kose et al (2013) (http://www.voxeu.org/article/why-global-recovery-different), public debt levels in advanced economies were much higher than in the past when the macroeconomic downturn took place. Public deficit levels had soared in the run-up to the recession, given the scale of financial support measures and substantial revenue losses. However, one may also say that a policy option for austerity was exercised. In the cases of the US and UK, financial markets were not imposing any substantial short-term fiscal retrenchment – especially if medium-to-long-term structural adjustment plans were to be announced. In the Eurozone, in turn, the intensity of fiscal adjustment in crisis-ridden members could have conceivably been lower provided that a correspondingly higher financial support from outside had been made available.
Unconventional monetary policies, in turn, came out of the urgency of halting potentially catastrophic processes of debt deflation and bank-credit freezes that threatened to transform solvent-but-illiquid balance sheets into insolvent ones. In the case of the Eurozone, such risks of financial meltdown were compounded by negative feedback loops between banks' portfolios and rising risk premiums associated with crisis-ridden national public debts.

Very loose monetary policies smoothed the process of private-sector balance-sheet deleveraging by keeping yields at low levels and propping up asset values. In the Eurozone, risk premiums abated after the European Central Bank pledge to do “what it takes” to keep currency convertibility.

The phasing out of unconventional policies has been protracted as a reflection of the sluggishness and feebleness of the macroeconomic recovery and the absence of fiscal stimulus as an alternative. In the Eurozone, the debt overhang is still salient and balance-sheet deleveraging still has some way to go, but certainly in the case of the US, where debt deleveraging has already been substantial, fears regarding consequences of the unwinding of quantitative easing have made it a measured and paced process.

Can one point out the single-handed reliance on monetary policy to counter downturn as a factor underlying actual GDP tracking behind potential levels? After all, most analysts attribute an asymmetric capacity to monetary policy in economic downturns: the ability to countervail risks of asset-debt deflation is not accompanied by an equivalently strong capacity to induce agents to invest in new productive assets. As the saying goes, “one can pull a string, not push it!” Furthermore, after a certain point, ultra-loose monetary policy would only lead to a repeat of the bubble-blowing process seen before the crisis.

In this sense, countercyclical moves by policy makers might have reduced the length and size of the observed output gap had fiscal policy operated as a countercyclical tool complementary to monetary policy. Regardless of whether restrictive fiscal policies have been a necessity or an option, the fact is that they have constituted a major factor leading to a subpar recovery performance.