Sustaining the recovery. Challenges on the supply and the demand side

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1. The Supply Side: Potential Output

- Direct legacy: Scrambling rather than cleansing ?
  - Weak banks and tight lending for awhile
  - SMEs and growth

- Indirect:
  - A more regulated financial sector.

    More stable but lower growth? The EM experience

  - Changes in composition:

    Less housing, less real estate and finance

    More net exports here (US), less there (EMs)

    More productivity growth here (US), less there. (EMs)

The evidence

- From past financial crises. Level loss in output
- Different this time?   Looking at the U.S.:
  - Evidence from productivity growth during the crisis
    - Two ways of looking at it
  - Evidence from output and inflation
    - Using evidence from output, inflation, capacity utilization
    - Not so good news

Following Banking Crises, Output Losses are Significant and Sustained

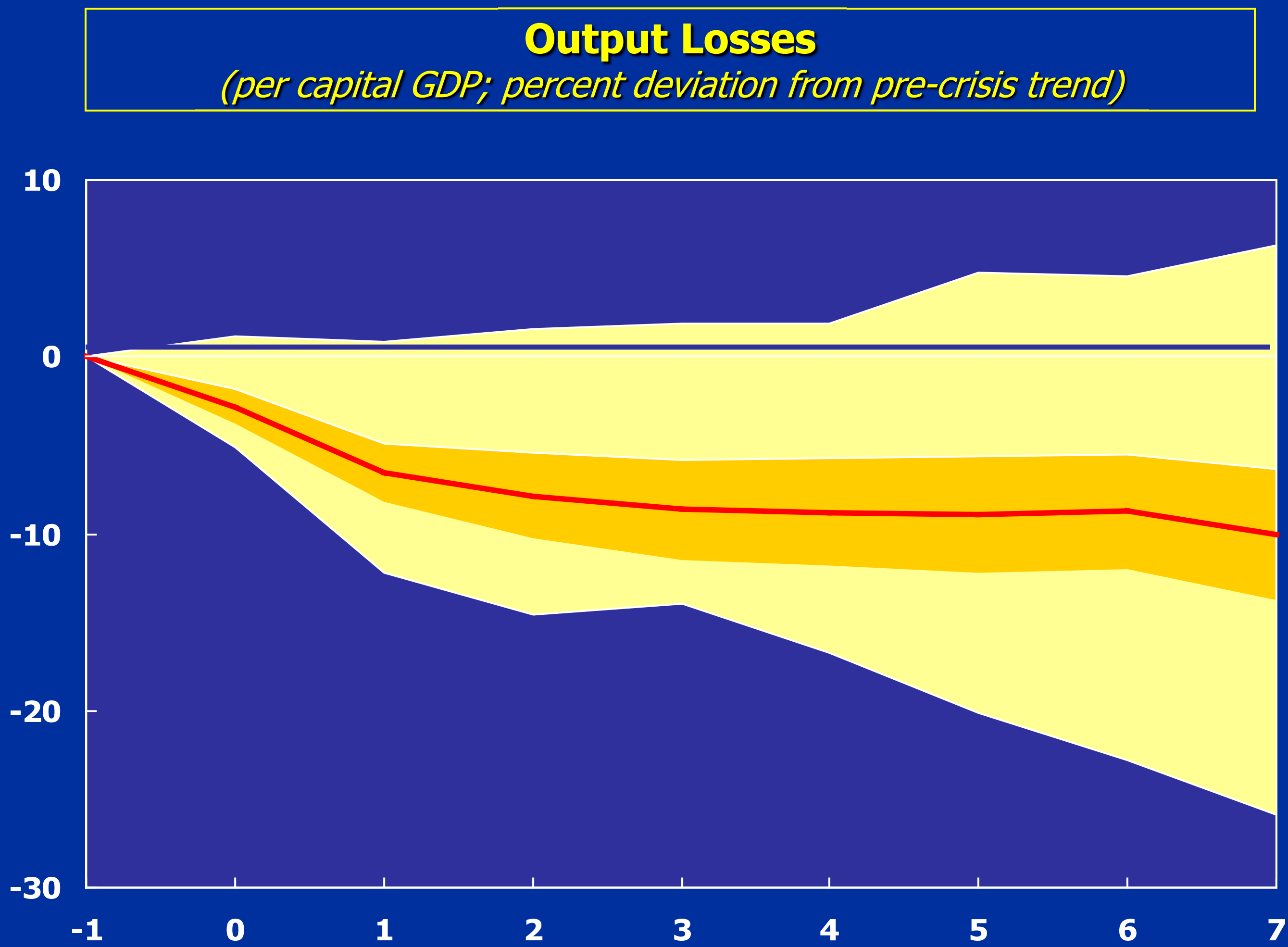
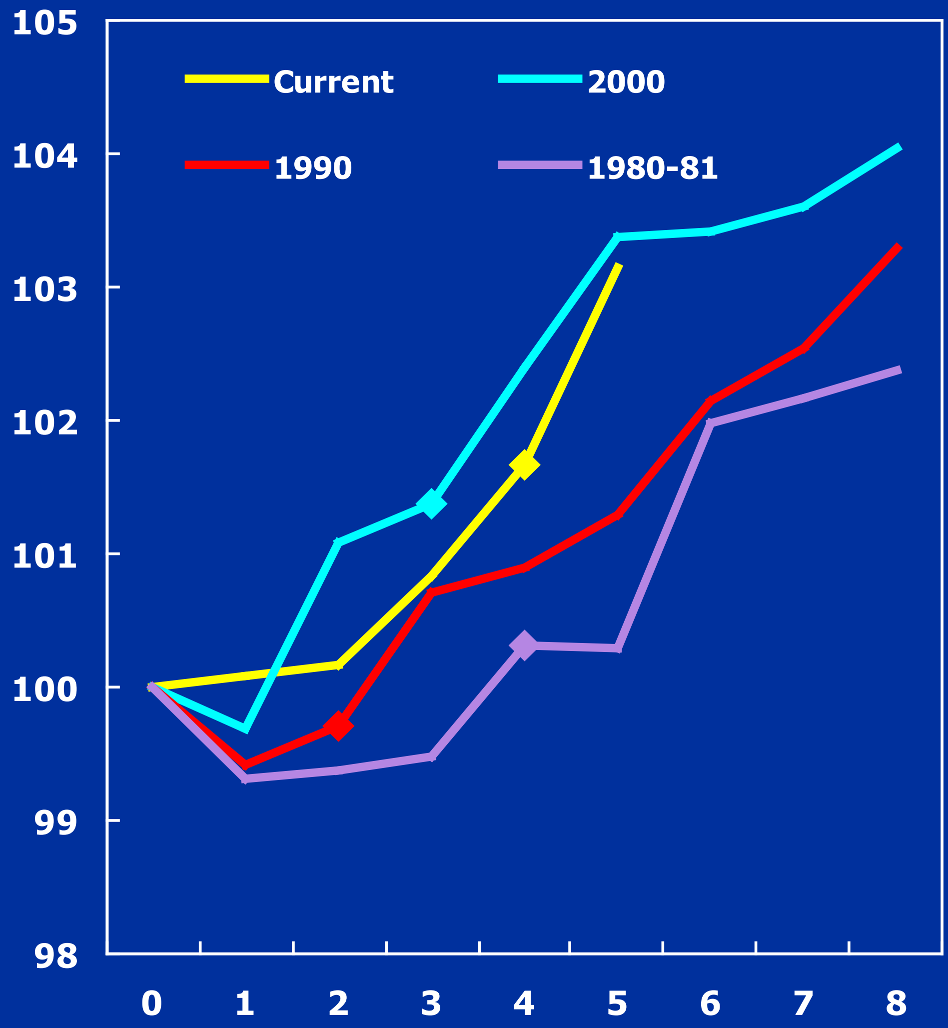


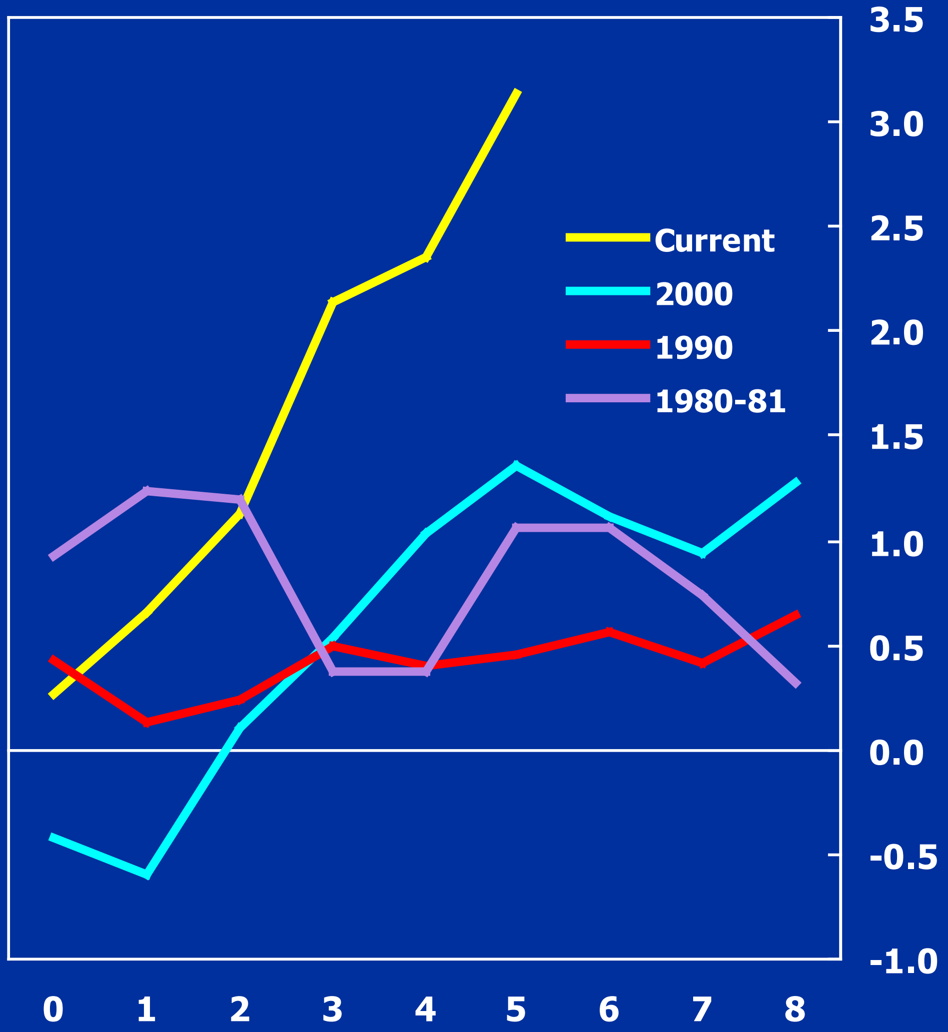
Figure reports mean difference from pre-crisis trend (over t-10 to t-3); t=-1 normalized to 0; crisis begins at t=0. Inner shading indicates 90% confidence interval for the mean; outer shading indicate inter-quartile range.

US: Behavior of output per hour during recessions

Output per Hour 1/
(index=100 at cyclical peak, t=0)



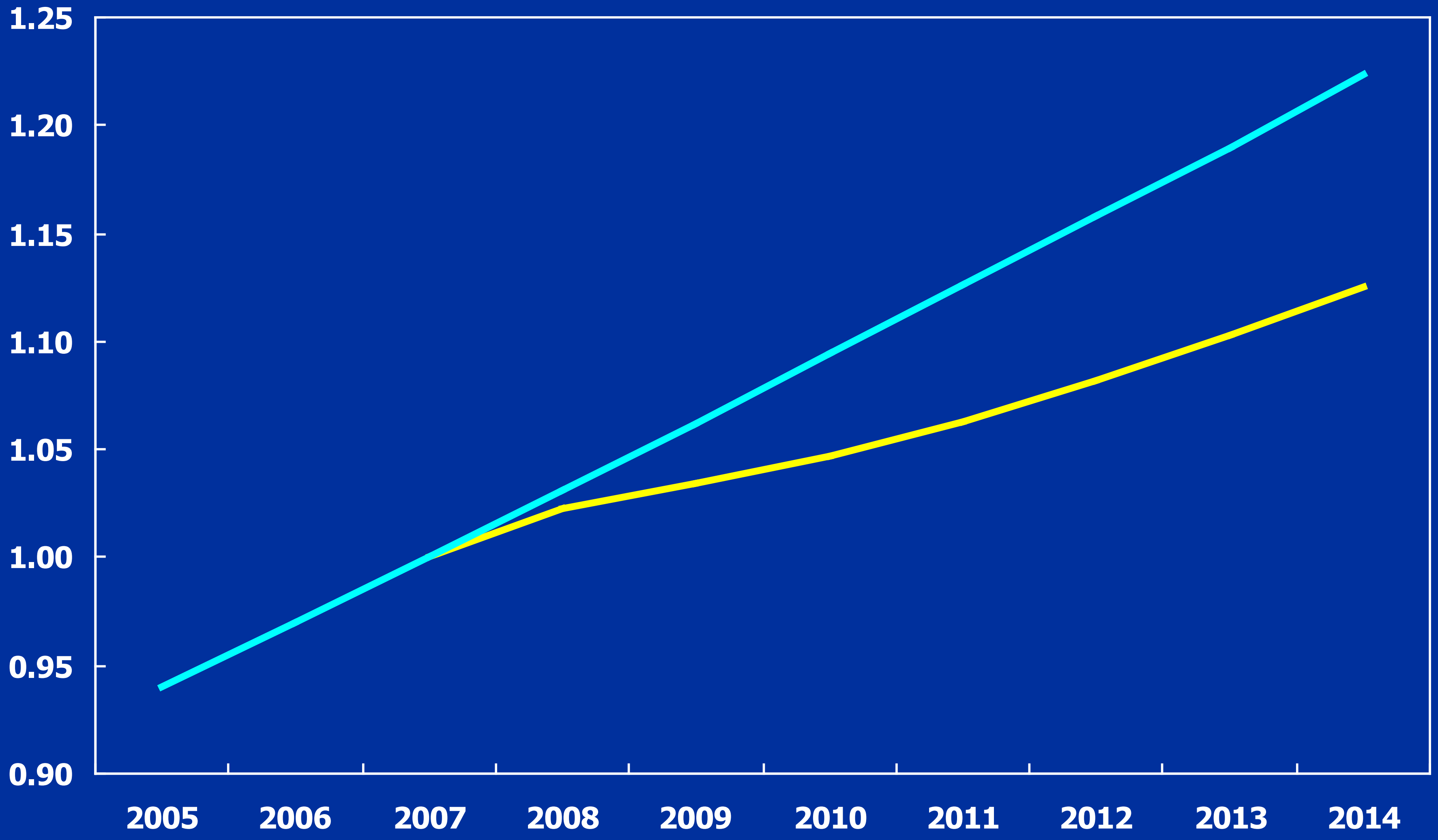
Output per Hour
(in percent; cumulative residuals)



1/ x-axis measured in quarters; 0 denotes peak in output; diamond markers indicate trough of recession).

U.S. GDP and Potential GDP Forecasts Versus WEO April 2007

(indices; potential GDP 2007=1)



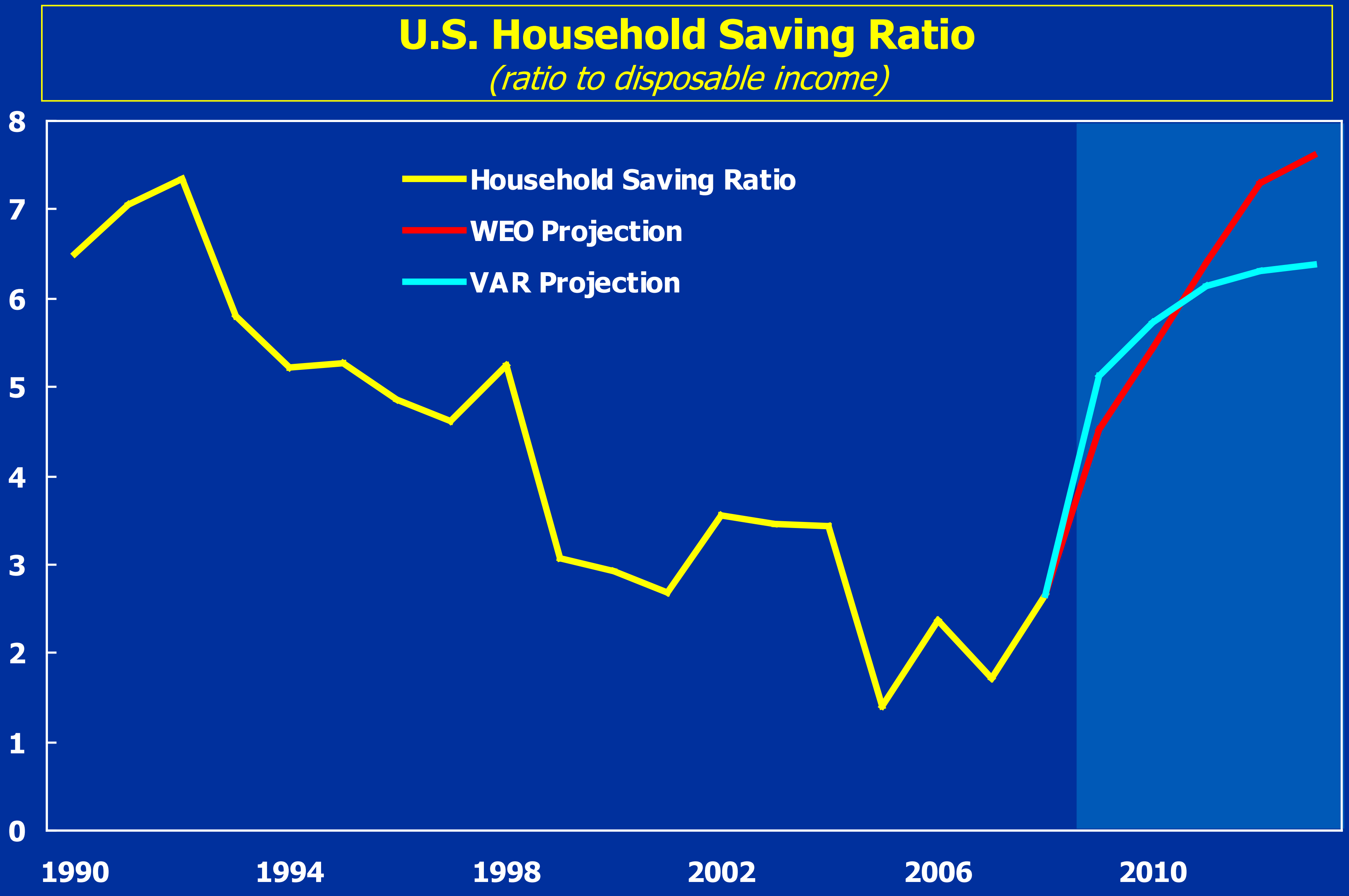
2. The Demand Side

- Increase in saving, more so here (US consumers) than elsewhere.

  For the moment, partly offset through fiscal, but not forever.

- Textbook adjustment:
  - Lower interest rates, more so here than elsewhere.
  - Higher aggregate demand.
  - Induced exchange rate adjustment.
  - Increase in NX here, decrease in NX there.

What will U.S. Consumers Do?



Serious Complications:

- Room to decrease interest rates is limited.
  - Back to the savings glut.

- Alternatives: Structural policies?
  - Increasing investment. (Green investment? Not enough.)
  - Decrease saving where desirable.

  - Implied exchange rate adjustments.
  - Delicate combination. What if not?

Real Interest Rates

(from breakeven inflation)