Discussion

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Introduction

This paper is a very careful study of business cycles in OECD countries and their latest changes. In particular, it studies the business cycles in the G7 and Australia, Belgium, the Netherlands, Spain and Sweden, for the period from 1970 to 2003.

The authors postulate that there is a linkage between ‘good’ policies and both macroeconomic stabilisation – in the business cycle frequency – and long-run growth. In discussing this hypothesis, several very important issues are raised. Some empirical evidence is also provided in support of the hypothesis.

The main findings of the paper are the following. First, confirming the results elsewhere in the literature, the paper reports different measures showing that business cycle volatility is less in recent years than it used to be. Why this is so is discussed in several papers in this conference, such as those by Robert Gordon, Steve Cecchetti and co-authors, and Christopher Kent and co-authors. Second, it is argued that it is difficult to identify an increase in business cycle synchronicity between these countries. Third, the paper argues that ‘good’ stabilisation and structural policies are linked to lower volatility in both prices and output, that is, short-run stability, and to better long-run performance, that is, higher output growth. Finally, the authors argue that the strong resilience shown during the recent cycle by countries like Australia, Canada, Spain and the UK can be linked to good structural policies – flexible regulation of labour, product and financial markets, put in place in those countries in previous years. In contrast, the paper shows that countries with more rigid regulations, such as the big continental European countries, showed less flexible prices and higher sacrifice ratios in the last cycle.

My discussion will evolve around two points. The first refers to the evolution of business cycle synchronicity. I discuss further evidence in the empirical debate on whether synchronicity has increased in the OECD or not. The second, more fundamental, point refers to the main hypothesis of the paper, that improved short- and long-run performance is linked to good policies, and in particular to flexible regulation of labour, product and financial markets. I essentially agree with the authors that this hypothesis is a reasonable one. In support of my position, I discuss the cases of Spain and Canada.

Business cycle synchronicity

The paper argues that, possibly due to generalised lower business cycle volatility, it is difficult to identify empirically an increase in business cycle synchronicity over time. The authors show this point by computing the standard deviation across countries of the output gap in Figure 4.

I would like to stress that it is important to note the asymmetry of the degree of synchronicity across business cycle phases; international business cycle synchronicity is higher in recession phases. This can be seen in that same Figure 4, as well as in the evidence shown in Cotis *et al*'s Figure 1 which is used to analyse the clustering of turning points across countries. Indeed, it is not by chance that academics and institutions intensified their research efforts on the issue of business cycle synchronicity in the last recession.

One such example is Canova, Ciccarelli and Ortega (2004), where a panel VAR is estimated – using Bayesian techniques – for quarterly growth rates of GDP, employment, retail sales and industrial production in the G7, allowing for both cross-country interdependencies and time variation. Each quarterly growth rate is decomposed into the sum of a world component, a country component, a variable-specific component and a residual. It is shown that both the world component and the country components are significantly more synchronised in recessions than in expansions. The following figure (Figure 1), borrowed from that paper, displays the posterior median and 67 per cent confidence interval for the world and seven country components. It can easily be seen that the confidence intervals narrow significantly around recessions.

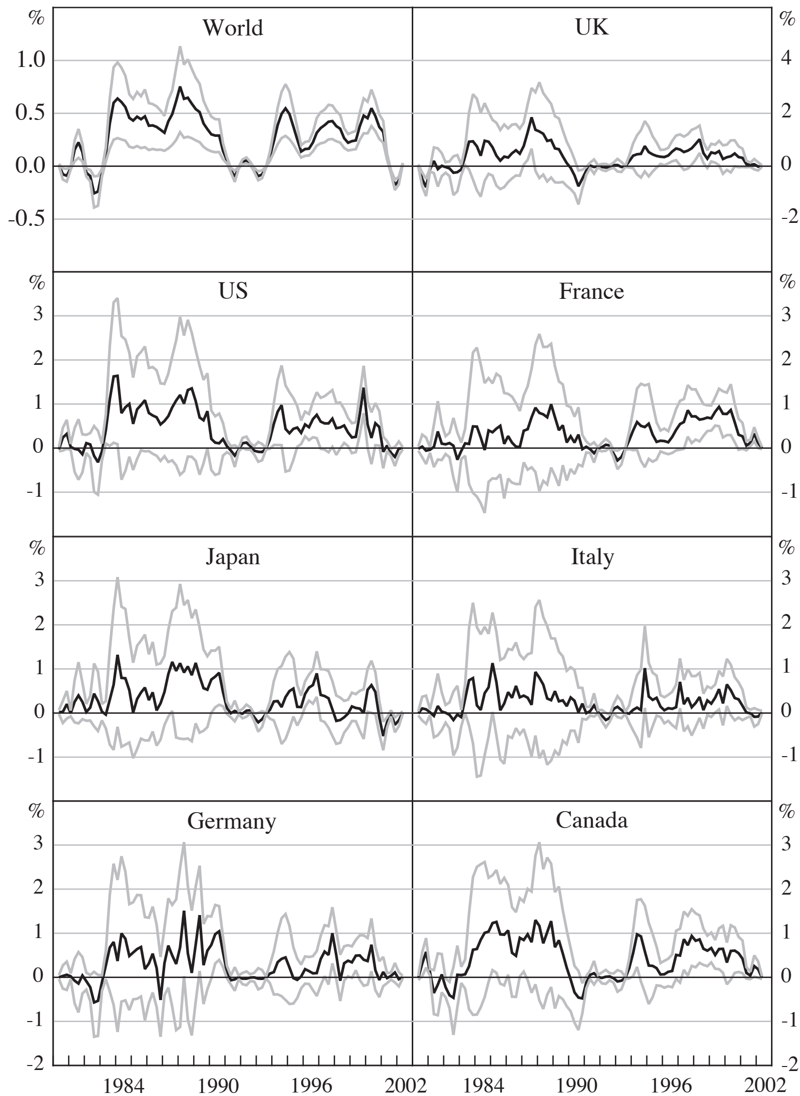
A second point I would like to discuss with respect to this paper's difficulty in finding increased business cycle synchronicity is the following. The recent empirical literature mentioned in the paper and elsewhere has found two apparently contradictory facts. On the one hand, country-specific factors are often found to be important and increasing contributors to volatility, but on the other hand, cross-country synchronicity is also found to be higher than in the past. Theoretically, the intensification of economic integration between industrialised economies is compatible with both facts: on the one hand increased integration means more cross-country trade, but on the other hand it can also mean increased industrial specialisation, and hence more scope for sector-specific shocks to cause different business cycle behaviour.

A recent example of a paper where these two facts are found is Cardarelli and Kose (2004). They estimate a dynamic factor model for the G3 and Canada and find that: (a) the explanatory power of the common cycle has increased in the 1980s and 1990s with respect to previous decades; but (b) idiosyncratic factors are still the biggest source of some countries' business cycle fluctuations (for example, Canada).

Both facts are not incompatible. Despite a common cycle being a consistent and significant explanatory factor of industrialised economies' business cycles in recent decades, the well-documented decrease in macroeconomic fluctuations in the 1990s has caused a reduction in the variability of, and hence the uncertainty around estimates of, common cycles and country-specific cycles. Country-specific cycles thus became a significant explanatory factor in the 1990s, together with the common cycle. In previous decades, however, estimates of country-specific cycles used to be insignificant due to their large variability. Figure 1 (taken from Canova *et al* 2004) illustrates this point.

The question, then, is why business cycle volatility dropped in the 1990s, an issue that is discussed at length elsewhere in this conference volume.

Figure 1: World and Country Indicators



Source: Canova *et al* (2004)

Good policies and macroeconomic performance

The authors show that after the last global recession, countries like Australia, Canada, Spain and the UK displayed a quicker recovery (essentially driven by private consumption and residential investment) while conducting similar monetary and fiscal policies to other, less resilient, countries. This observation leads them to postulate that this different behaviour was due to the more resilient countries having a higher degree of structural flexibility.

The paper goes on and summarises results from previous OECD studies, showing that countries with more flexible regulation of labour, product and financial markets also have more flexible price systems. Hence, they were more resilient after the last recession, and have stronger potential growth rates.

It is a very important contribution of this paper to document as much as is possible the extent to which this hypothesised linkage between flexible regulation schemes and stabilisation and growth is empirically valid.

I agree that there is evidence that justifies taking this hypothesis seriously. I will try to show that the cases of Spain and Canada confirm the role that this paper attributes to good policies. Both countries conducted a series of structural reforms in the 1990s and disciplined monetary and fiscal policies, that very likely gave their respective economies the structural flexibility referred to by Cotis and Coppel. These 'good' policies very likely mean that these two economies were better placed to face a recession.

It is easy to suspect that Spain has a higher degree of structural flexibility than the other big euro-area economies if one compares recent economic growth rates. GDP growth in Spain in 2004 was 3.1 per cent – substantially higher than in France, Germany or Italy, despite a common monetary policy.

In fact, Spain put in place a number of significant reforms in the 1990s. Very importantly, several measures led to substantially more flexible regulation of the labour market. The result was the creation of a mass of very flexible employment (more than 30 per cent of employment is temporary) that allowed the economy to create jobs and increase growth at the same time. The flows into and out of employment in Spain have reached the levels observed in the US economy.

Another important 'good policy' was the fiscal discipline imposed since the mid 1990s, the result of which has been the maintenance of a fiscal surplus.

Finally, it is also important to stress the fact that financial intermediaries are reasonably flexible and competitive, and much more so than in other big euro-area economies. In particular, low margins on mortgage loans in Spain ensure it has the lowest mortgage rates in Europe.

In the case of Canadian resilience after the 2001 recession, it has to be said that this recession affected the Canadian economy less than, for example, the US, partly because of a smaller presence of the high-tech sector in Canada.

But it is also true that the Canadian economy conducted a number of substantial reforms in the mid 1990s. In the labour market, some benefits (including unemployment insurance) were made less generous. On the fiscal side, a big shift was

made from very large Federal deficits to a tighter fiscal policy. Since the mid 1990s, the Federal budget has shown a surplus and there has been a downward trend in the public debt-to-GDP ratio.

Monetary policy discipline was strengthened with the implementation of inflation targeting in February 1991. Inflation targeting provided an effective anchor for inflation expectations that allowed increased nominal stability (observed, for example, in an increase of longer-duration labour and financial contracts) and, more generally, brought increased macroeconomic stability (that is, lower business cycle volatility).

The financial sector went through a significant internal restructuring in the mid 1990s. Most financial institutions reduced their share of loans to the energy-producing sector and increased their share directed to consumer financing. This allowed for a substantial improvement in the cyclical performance of the financial sector. Also, in order to understand the role of financial institutions in the monetary policy transmission mechanism, it has to be noted that mortgages are in general more sensitive to monetary policy actions than in the US; the share of mortgages with variable rates, or adjustable after one or two years, is higher in Canada.

Finally, it is worth mentioning the gradual deregulation observed in Canadian product markets since the 1980s, like the energy-producing and transportation sectors.

It makes a lot of sense to suspect, as it is argued in this paper using different pieces of evidence, that these and similar policies increased the resilience of the Spanish and Canadian economies in the previous cycle.

References

Canova F, M Ciccarelli and E Ortega (2004), ‘Similarities and convergence in G-7 cycles’, European Central Bank Working Paper No 312.

Cardarelli R and MA Kose (2004), ‘Economic integration, business cycles and productivity in North America’, IMF Working Paper No WP/04/138.

2. General Discussion

Most of the discussion centred on the underlying differences between the structures of European and ‘successful’ countries’ economies. One participant questioned why the characteristics of mortgage markets in continental Europe are so different from the US, for example, and suggested that the lack of development of the European market might reflect less desire by European households to smooth consumption, due to weaker expectations about future income. While noting that this may be true, another participant added that the inflexibility of European mortgage markets is due mainly to stricter government regulation and political inertia. However, this emphasis on government regulation was challenged by a third participant, who argued that inflexibility is deeply ingrained in European legal systems and, in particular, in the

inability of creditors to access collateral following default. This participant noted that flexibility might increase with legal harmonisation, although others expressed reservations that this process could be quite prolonged.

A second issue raised was the role of openness, rather than domestic demand resilience, in smoothing output volatility. One participant questioned the absence of globalisation as a reason for the reduction in volatility in Cotis and Coppel's paper, arguing that greater openness increases the effectiveness of monetary policy. In response, Jean-Philippe Cotis argued that while this is true, the reduction in volatility is more evident in domestic demand than GDP – particularly in the most recent recession – a point that was supported by other participants.

The importance of country idiosyncrasies for the paper's results was also discussed at some length. One participant suggested that the reunification of Germany and the ERM devaluation were important in stimulating the recovery of the non-'successful' countries in the early 1990s, thereby contributing to the decline in the cyclical performance of these countries between the early 1990s and early 2000s. Accordingly, it was suggested that this idiosyncrasy makes the relative improvement in the performance of the 'successful' and non-'successful' countries during the past decade more pronounced. Similarly, it was noted that the reduction in European volatility has been much less than that seen in the US (Table 4 of the paper), and that this may be due to US-specific factors (such as volatility in government spending and interest rate ceilings) which were important in increasing US output volatility, in particular during the 1970s. This suggestion that idiosyncrasies have played an important role was accepted by Jean-Philippe Cotis. However, he added that a striking feature is how similar the economic performance of the 'successful' countries has been, despite their geographical diversity, and that this surely has something to do with the common traits among these countries (inflation-targeting-type monetary policy and flexible markets).

A more general concern raised by a participant was that researchers should not focus on output gaps when looking for the effects of structural reforms. The problem is that output gaps filter out changes in trend growth, but trend growth is likely to be more responsive to structural change than is the volatility of growth (particularly if the transmission of shocks is unaffected by structural reforms). Hence, given that there is little evidence of changes in trend growth, it is likely that supply-side reforms have had only a minor part to play in the reduction of the standard deviation of output, in contrast to the authors' findings. This point was accepted by Jean-Philippe Cotis, but with the qualification that the structural reforms addressed in the paper are also important for demand. For this reason, it was argued that they may also impact output dynamics, and thereby have reduced output volatility.

Finally, a few participants raised the question of whether the focus of 'successful' countries on core inflation over a relatively short horizon would lead to longer-term problems. Indeed, one participant suggested that these economies might be *too* responsive to monetary policy changes, due to the substantial increase in household leverage in those countries over recent years. In response to this, it was argued that this is preferable to having an economy which is rather insensitive to policy changes, as appears to be true of some other countries in the paper.