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Meet IMF Research Perspectives,

the bulletin with sharper storytelling, richer design, and more

When you read the Spring/Summer 2018 issue of the IMF Research Perspectives (formerly published as *IMF Research Bulletin*), if we did it right, you will meet the more approachable, more human side of IMF research and IMF researchers.

The bulletin has just turned 18, and we thought this was a good time to revamp the design and content. How? First, we transformed our Q&A feature into a complete interview. Second, we added more research summaries to give you a better sense of what IMF research has to offer on recent topical issues. Third, we changed the design to make your reading experience more enjoyable and reaching out to the contributors easier. And, of course, we changed the name to Perspectives, which we feel more accurately reflects our new approach focused on sharing views and encouraging interaction. One thing that hasn't changed is our commitment to conduct and disseminate state-of-the-art, policy-relevant research to foster further discussion for better policymaking around the world.

Such an undertaking would not have been possible without a dedicated group of individuals: the guest editorial team led by Sweta Saxena and the design team led by Felipe Leon deserve the utmost credit.

We hope you will like our fresher, bolder look. Let us know what you think.

Deniz Igan and Chris Papageorgiou

Note from the guest editor

It has been ten years since the Global Financial Crisis and, around the world, output is yet to fully recover. Moreover, the gains from this slow recovery have largely benefited the relative few, helping to spawn a rise in populist movements in the developed world. The global economy has to confront new challenges from technology and automation (the changing nature of work) and the deployment of big data projects (quality and governance aspects). These portend a better future but also raise fears of further widening the gap between the haves and the have-nots. Perhaps what is missing in this big picture is how the focus of policies can be changed from external values (such as competition, consumption, and profits) to internal values (such as cooperation, compassion, and happiness). The articles in this edition shed light on these issues and how, in the future, economic policies need to evolve to balance tradeoffs and be more supportive and inclusive.

Sweta C. Saxena

q&a with Hites Ahir

Photo: Michael Spilotro

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Interview

THE GLOBAL FINANCIAL CRISIS

10 Years On, Why Many Still Feel the Pain

Interview with Valerie Cerra

The Global Financial Crisis of 2007-08 was the worst to hit the world economy since the Great Depression. The Crisis devastated the financial markets, brought the housing and banking sectors to their knees, and caused political upheaval in both the developed and developing world. Ten years on from those events, Hites Ahir talks to Valerie Cerra, Assistant Director in the IMF's Institute for Capacity Development, about why some countries still haven't been able to fully recover, what are the implications of recessions and crises for policymaking, and the new stylized model for economic development.

Hites Ahir: As you know, it is about ten years since the onset of the Global Financial Crisis. A search for "global financial crisis" in Google shows about 14 million results, while Google Scholar shows more than 256,000 results. Do you think we have answered all the questions about the crisis?

Valerie Cerra: In some ways, the global financial crisis shook up the economics profession. At the IMF, we have been accustomed to dealing with crises and other adverse shocks affecting many of our member countries. But the economics profession at large was taken by surprise by the crises in advanced countries. The prevailing assumption had been that economic policy, especially led by central banks, had evolved to maintain economic stability and preserve the "Great Moderation." Some economists also underestimated the role of the financial sector before the crisis. During the past decade, a lot of good work has been done to incorporate financial frictions into our economic models.

Even so, the profession has been much slower to recognize the protracted impact of shocks, sometimes called "hysteresis," or the dependence of the economy on its history. We still don't understand very well why transitory shocks from the financial sector or elsewhere can lead to a persistent fall in productivity, employment, and investment. This poses a fundamental challenge to our theories of the business cycle and economic growth, also calling into question the conventional distinction between "supply shocks" and "demand shocks."

Ahir: After the crisis, some experts predicted a quick economic rebound, while others predicted a slow economic rebound. Could you give us a quick summary of the different views, and the rationale behind them?

Cerra: Most experts, including those responsible for official projections, such as the Council of Economic Advisors, and prominent academics, predicted a quick rebound of economic activity to the pre-crisis trend. They thought GDP growth would be rapid as capacity came back into use and unemployment declined during the economic recovery. Only a minority of experts were skeptical of this optimism, based on their review of historical data.

Ahir: It sounds like you were one of those in the minority. In the paper Booms, Crises, and Recoveries: A New Paradigm of the Business Cycle and its Policy Implications which you co-authored with Sweta Saxena, you argue that crises and recessions tend to permanently depress the level of a country's output. Can you elaborate on that?

Cerra: Our paper debunks the traditional view of the business cycle in which output declines temporarily during a recession and then rebounds quickly to its initial upward trend line during the recovery. Instead, we argue that most recoveries consist only of a return of growth to its long-term expansion rate—without a high-growth rebound back to the initial trend. In other words, recessions trigger a drop in the trend rather than a deviation from trend.

Ahir: So, you are saying that the business cycle is not actually a cycle? Does the data back up your claim?

Cerra: Correct. Using updated data, we confirm our earlier findings (in IMF WP/05/147) that all types of recessions, on average, lead to permanent output losses, not just those associated with financial and political crises. We also show that countries do not typically have strong growth booms before crises and recessions.

> "In other words, recessions trigger a drop in the trend rather than a deviation from trend."

Ahir: In the paper, you also say that the conventional "output gap" is ill-measured and ill-conceived. Why? And what are the pitfalls for monetary and fiscal policymakers if they use this conventional measure?

Cerra: The conventional concept of the "output gap" is intended to represent temporary deviations of output around its long-term trend. But this concept no longer has much meaning if shocks to output move

its entire trend. We also show that constructing output gaps by fitting a smooth line through historical GDP data—either by using a simple filter or a more complex structural estimation procedure—leads to spurious cycles and constant revisions to historical estimates. In fact, current estimates of the 2007 output gaps for all of the advanced countries are very positive—implying strong economic booms on the eve of the global financial crisis—although they were estimated to be small or even negative at the time. This revised view of history is purely a statistical artifact of creating smooth trends through structural breaks, such as permanent output declines, in the GDP data.

Policymakers can face large pitfalls using these conventional output gap concepts and estimates. For example, after a large negative shock, a "cyclically adjusted" fiscal deficit is likely to appear more favorable than the actual deficit. Fiscal authorities may erroneously assume that an expected economic recovery will automatically eliminate the cyclical part of the deficit. But that will not happen if there is no fast rebound and the level of GDP—and the associated fiscal revenues—remains below the prior trend. Likewise, central banks should focus on direct measures of inflation pressure rather than on unreliable measures of the output gap.

Ahir: The results of your study point to a new model of long-term economic development. What does this mean for poor countries?

Cerra: We show that poor countries are quite capable of sustaining periods of strong growth and catching up to rich countries, consistent with neoclassical theory. Their failure to do so during the postwar period is largely due to their more frequent and deeper recessions compared with rich countries. Since shocks to output have permanent effects, these frequent and deep recessions drag poor countries down from their convergence paths.