Essays in the Great Recession and the Austerity

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In the first paper, "The Great Recession: Divide between Integrated and Less Integrated Countries" (with Eric van Wincoop and Gang Zhang), we point out that no robust relationship has been found between the decline in growth of countries during the Great Recession and their level of trade or financial integration. In the paper we confirm the absence of such a monotonic relationship, but document instead a strong discontinuous relationship. Countries whose level of economic integration (trade and finance) was above a certain cutoff saw a much larger drop in growth than less integrated countries, a finding that is robust to a wide variety of controls. We argue that standard models based on transmission of exogenous shocks across countries cannot explain these facts. Instead we explain the evidence in the context of a multi-country model with business cycle panics that are endogenously coordinated across countries.

In the second paper, "A Welfare State-based Fiscal Multiplier", I suggest a mechanism that helps to explain how cuts in public expenditures can trigger a recession. Announcements of cuts in welfare state spending components such as health, education or social protection can induce households to save, either because welfare state goods can be privately replaced, or because an expected loss in public transfers can be compensated with private savings. If output is demand determined (due for example to nominal or real rigidities), a drop in private consumption decreases demand, raises unemployment and decreases output which prevents households from saving, a version of the Paradox of Thrift. This link between announced fiscal consolidation and current output strengthens as future risk faced by the households increases, because welfare state spending has a strong insurance component (precautionary motive). Announcement of future tax hikes can also induce a drop in output, but the effect of welfare expenditures tends to dominate the former as future uncertainty increases. I bring the model predictions to the data, focusing on the austerity period (2010-13) and I find that: (i) among the fiscal instruments used at the time, cuts in welfare expenditures was by far the strongest one related to GDP growth, with the use of IV techniques and the estimation of fiscal shocks suggesting causality, (ii) looking at the composition of fiscal adjustments, those based on welfare state cuts were more likely to decrease output, and (iii) these effects become stronger as future risk faced by consumers increases.

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