Ahir: Since the crisis, there has been a lot of talk about regulation, more regulation vs. less regulation, monetary policy, price stability vs. financial stability, and the optimal level of foreign exchange reserves. What do your findings imply for each of these topics?

Cerra: Economic policies should be geared toward avoiding costly crises and severe recessions and building buffers that allow policymakers to respond with appropriate stimulus and safety nets to negative shocks. Policymakers should discourage excessive risk-taking in the financial sector through, on the margin, more regulation than had been imposed before the crisis. Monetary policy may need to play a role in addressing financial stability risks if regulation is insufficient and, at a minimum, should avoid exacerbating asset price and housing bubbles.

Foreign exchange reserves can help insure against losses from adverse external shocks. But the optimal level of reserves may be higher than previously estimated, given our findings that losses associated with crises are persistent rather than temporary. More generally, our work has found that an economic stimulus can help deliver a partial output rebound in the aftermath of a severe recession or crisis. That is, although recessions and crises generate permanent output losses, on average, there is heterogeneity in the outcome that depends on the policy response during the downturn. Thus, countries should build policy space during good times to use as ammunition when facing adverse shocks.

Ahir: There are studies that have linked the large and persistent output losses from financial crises and deep recessions with populist pressure for change, and backlash against globalization. Could you talk a bit about that?

Cerra: Hysteresis from financial crises and deep recessions depress employment and household income, which often leads to populist pressure for policy changes that inadvertently further reduce growth and social welfare. For example, political polarization rises after systemic financial crises (Mian and others, 2014) and far-right political parties earn higher voting shares (Funke and others, 2016). In a negative feedback loop, trade protectionism may rise, which can lower incentives to invest and trade and thus further reduce growth. ■


Photo: Michael Spilotro

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THE RISE OF POPULISM: IS IT *really* THE ECONOMY, STUPID?

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A quick read of the news would have you believe that populism is on the rise following the Great Recession.

At the same time, concerns about inequality loom over policy debates and discussions have focused on the merits and disadvantages of globalization and how certain groups in society have become vulnerable to technological progress. Are these causes related to the rise in populism?