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HOW CAN RECESSIONS BE BROUGHT TO AN END? EFFECTS OF MACROECONOMIC POLICY ACTIONS ON DURATIONS OF RECESSIONS

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This paper analyzes how effective macroeconomic policy actions are in ending recessions. We also investigate which structural factors help the country to experience shorter recessions. We implement survival regression analysis and conclude that expansionary monetary policy significantly decreases durations of recessions whereas fixing the exchange rate does not have an effect on the durations of recessions. Expansionary fiscal policy has undesired effects and decreases the probability that recession will end, thus increasing the durations of recessions. The analysis of country specific factors indicates that emerging countries experience shorter recessions. Recessions in countries with higher trade openness last significantly longer. Financial openness and institutional quality do not have significant effects of recession durations. The empirical analysis takes into account alternative probability distributions and endogeneity of policy actions.

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"... economists seem strangely unsure about what to tell policy-makers to do to end recessions."
Romer and Romer (1994: 1)

I. Introduction

There is an ongoing debate about optimal macroeconomic policy during recessions. Policy reactions aim to end recessions as quickly as possible, decreasing their durations. Although there are many studies which investigate the factors that start recessions, or affect the probability of being in a recession, the analysis of macroeconomic policy and factors that end recessions, or decrease their duration, is limited.

In this paper, we take the statement of "ending the recession" literally and analyze the factors and policy actions that affect the probability that the recession will end by looking at hazard rates of recessions. We implement survival-time analysis to investigate the following questions. First, does the structure of the country at the start of recession have an effect on the durations of recessions? Second, how do macroeconomic policy actions affect durations of recessions? The first question leads to examine the effect of structural factors (trade openness, financial openness, institutional quality, and being an emerging country) on recession duration, to see which countries are more resistant to recessions and shake the recessions off more quickly. The second question focuses on the comment by Romer and Romer (1994) and leads to investigate the effectiveness of macroeconomic policy actions to end recessions. The effect of monetary expansion, fiscal expansion and change in the exchange rate regime on the probability that the recession will end (the hazard rate of recession) is examined.

A large body of research analyzes the causes and effects of recessions. For instance, Claessens et al. (2011) analyze recessions in 23 emerging and 21 OECD countries. They find that recessions in emerging markets are deeper compared to developed countries when the amplitudes of recessions are considered. They identify that the recessions associated with financial crisis in emerging markets last longer and cause larger decreases in output. Among papers that investigate the implication of recessions in emerging markets, Chang et al. (2009) and Kose et al. (2006) analyze the linkages between long-term growth and short-term business cycle volatility using panel data sets, while Neumeyer and Perri (2005) analyze the effects of various shocks on business cycles in emerging markets using stochastic dynamic models.