



The global financial crisis: How similar? How different? How costly?

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ARTICLE INFO

Article history:

Received 12 February 2010

Accepted 16 February 2010

JEL classification:

E32

E44

E51

F42

Keywords:

Global financial crisis

Similarities

Differences

Cost

Recessions

ABSTRACT

This paper provides a brief analysis of three major questions raised in the context of the recent global financial crisis. First, how similar is the crisis to previous episodes? We argue that the crisis featured some close similarities to earlier ones, including the presence of credit and asset price booms fueled by rapid debt accumulation. Second, how different is it from earlier episodes? We show that, as much as it displayed some similarities with previous cases, it also featured some significant differences, such as the explosion of opaque and complex financial instruments in a context of highly integrated global financial markets. Third, how costly are recessions that followed these types of crises? Although the latest episode took a very heavy toll on the real economy, we argue that this was not a surprising outcome. In particular, historical comparisons indicate that recessions associated with periods of deep financial disruptions result in much larger declines in real economic activity. We discuss the implications of these findings for economic and financial sector policies and future research.

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1. Introduction

The global economy is recovering from the deepest recession in the post-World War II era. The global recession was triggered by a severe financial crisis in key advanced economies that coincided with the freezing of global financial markets and the collapse in global trade flows. While the crisis quickly resulted in deep recessions in a number of advanced economies, the emerging market and developing economies were also seriously affected, but the impact varied across regions and countries.

Although the process of global economic recovery is already underway, the nature and implications of the crisis have still been at the center of academic and policy discussions.¹ For example, there has been an intensive discussion about the similarities and differences between the latest crisis and the past episodes. Some commentators, especially in the media, argue that the latest crisis was different. Its root causes are thought to lie in the excessive global savings (a “savings glut”), flowing through a poorly regulated shadow banking system in the United States to its housing market (see Krugman, 2009). Some others claim that the idea of this crisis being different is misleading as an analysis of earlier crises presents remarkable similarities with the latest episode. In particular, excessive accumulation of debt, as it took place in various forms ahead of the latest crisis, was also a feature of previous crises (see Reinhart & Rogoff, 2009).

Another dimension of the ongoing discussions about the crisis has focused on its global spread and cost. The crisis originated in the United States, but it took place in a highly integrated global economy where the widespread use of sophisticated financial instruments along with massive international financial flows facilitated its rapid spread across markets and borders. Although it was not surprising that a global crisis led to a significant decline in global activity, the

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¹ A number of papers provide detailed discussions about the evolution of the crisis, see Borio (2008), Brunnermeier (2009), Calomiris (2009), Gorton (2009), and Shin (2009).

extent and duration of this decline have been a major area of research. Recessions associated with the global financial crisis, while displaying similar patterns with previous recession episodes, reflect an unlikely confluence of factors. Specifically, current recessions are associated with serious financial disruptions, including credit crunches, house price busts, equity prices busts and outright banking crises, in some countries.

This paper provides a brief analysis of the nature and cost of the crisis to shed light on these issues. In particular, we address three major questions. First, how similar is the latest crisis to previous episodes? Second, how different is the crisis from earlier ones? Third, how costly are recessions coinciding with serious disruptions in financial markets? In Sections 2 and 3, we study the first two questions. Our basic conclusion is that the massive financial crisis that has gripped the global economy over the past 2 years is a result of a multitude of factors. Some of these factors are similar to those observed during the buildup to past financial crises, but some others are distinctly new. While ranking the relative contributions of these various factors is difficult, together we think that they help explain the latest episode's considerable scale and scope. Irrespective of these similarities or differences though, the crisis has been a very costly one for both real and financial sectors as we discuss in Sections 4 and 5.

How similar is the latest crisis to previous episodes? We examine the similarities in the buildup to the crisis and in the post-crisis busts in Section 2. The buildup to the financial crisis has four major features similar to earlier episodes: First, asset prices rapidly increased in a number of countries before the crisis. Second, a number of key economies experienced episodes of credit booms ahead of the crisis. Third, there was a dramatic expansion in a variety of marginal loans, particularly in the mortgage markets of several advanced economies, which together led to a sharp increase in systemic risk. Fourth, the regulation and supervision of financial institutions failed to keep up with developments. These factors combined sharply increased the risk of a financial crisis. As we present in Section 2, the succeeding bust has many similarities to past events as well.

How different is the latest crisis from previous crises episodes? As we present in Section 3, new dimensions played important roles in the severity and global scale of the crisis that included surprising disruptions and breakdowns of several markets in the fall of 2008. The crisis was different than previous ones in at least four new aspects. First, there was a widespread use of complex and opaque financial instruments. Second, the interconnectedness among financial markets, nationally and internationally, with the United States at the core, had increased in a short time period. Third, the degree of leverage of financial institutions accelerated sharply. Fourth, the household sector played a central role. These new elements combined to create unprecedented sell-offs in the fall of 2008 and resulted in the global financial crisis.

How costly is the latest episode? The global financial crisis resulted in recessions in almost all advanced countries. Most of these recessions were accompanied by credit crunches, house price busts, and outright financial crises. In Section 4, we provide an analysis of how recessions associated with credit crunches, house prices busts and financial crises differ from other recessions. Our results suggest that recessions with credit crunches or house price busts result in more costly macroeconomic outcomes than do those without such disruptions. When recessions are accompanied with financial crises, the costs are larger and much more pronounced for consumption and investment.

Section 5 presents the dynamics of the ongoing recession in the United States, the epicenter of the current crisis, and compares them with those of past recessions in advanced countries. We also provide a short discussion about the speed and extent of deterioration of activity in the United States. Our findings suggest that the current U.S. recession is clearly an outlier in many respects.

The financial crisis has taken a heavy toll on the real economy as evidenced by deep and long recessions in a number of advanced countries besides the United States. The cost of a recession is, of course, affected by a number of factors. Section 6 presents a brief discussion of these factors, discusses policy implications, and concludes.

2. The crisis: how similar?²

The buildup to the ongoing financial crisis has four features similar to earlier episodes: First, asset prices rapidly increased in a number of countries before the crisis. Second, a number of key economies experienced episodes of credit booms ahead of the crisis. Third, there was a dramatic expansion in a variety of marginal loans, particularly in the mortgage markets of several advanced economies, which together led to a sharp increase in systemic risk. Fourth, the regulation and supervision of financial institutions failed to keep up with developments.

2.1. Asset price booms

The exuberant pattern of asset prices in the United States and other advanced countries prior to the current crisis is reminiscent of those observed in earlier major financial crises episodes in the post-war period. The overall size of the U.S. housing boom and its dynamics – including rising house prices in excess of 30 percent in the 5 years preceding the crisis and peaking six quarters prior to the beginning of the crisis – is remarkably similar to house price developments in the so-called Big Five banking crises episodes (Finland, 1991; Japan, 1992; Norway, 1987; Sweden, 1991; and Spain, 1977).³

² A number of papers examine the differences and similarities between the latest episode and past crises (see Furceri & Mourougane, 2009). Some parts of Sections 2 and 3 extend Claessens (2010) and Claessens, Dell'Ariccia, Igan, and Laeven (2010).

³ Reinhart and Rogoff (2008) examine the run-up in housing prices in the United States before 2007 and “Big Five” crises in advanced countries and confirm significant increases in housing prices prior to financial crises, and marked declines in the year of crisis and in subsequent years. They note that the run-up in housing prices, though, prior to the U.S. 2007 crisis exceeds that of those prior to Big Five.

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