World Economic Outlook

Presentation by Subir Lall

October 2008

Chapter IV

Financial Stress and Economic Downturns

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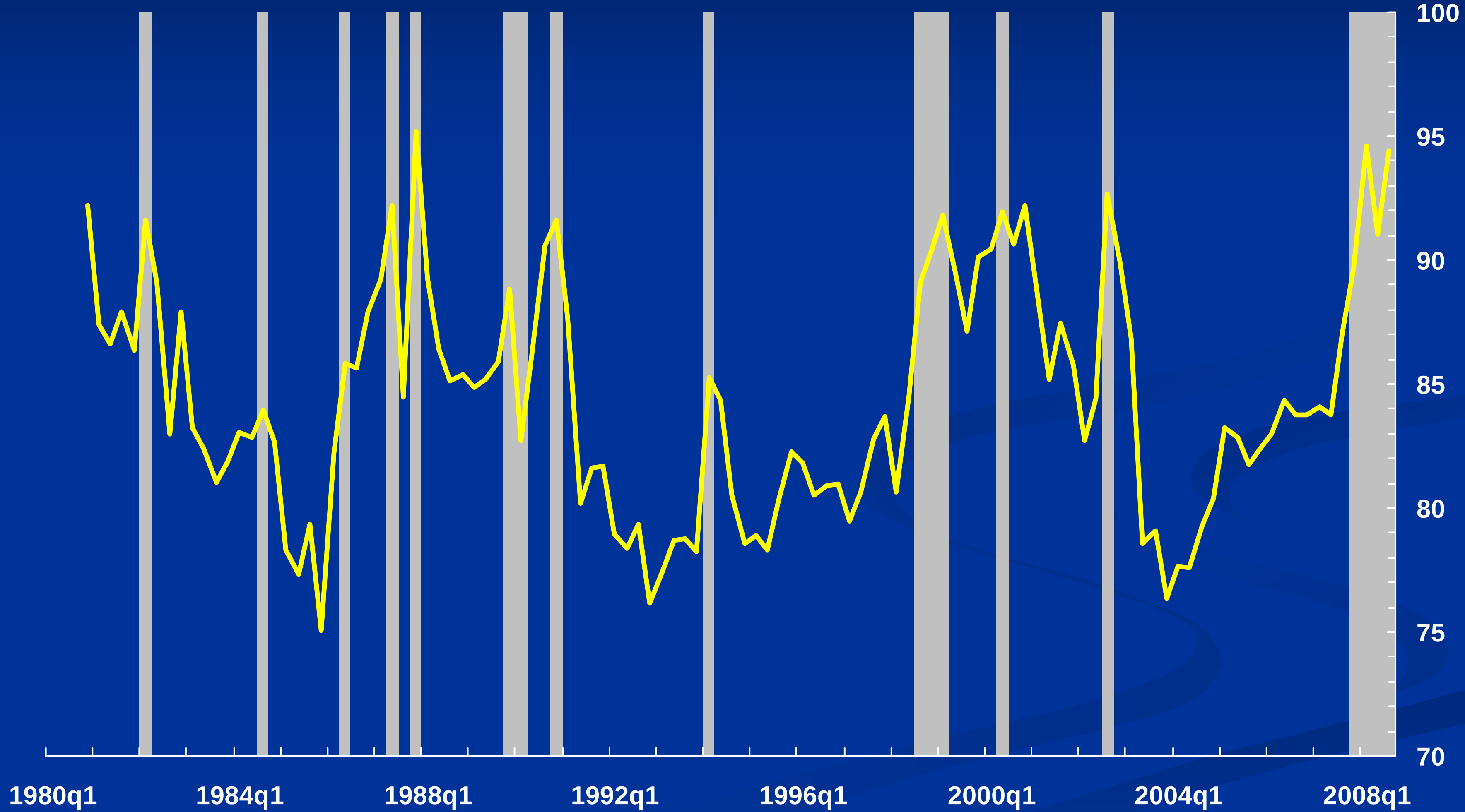
Key Findings

- Financial turmoil more likely to be followed by severe and protracted downturns when
  - characterized by banking sector distress
  - preceded by rapid increases in credit, a run-up in house prices, and heavy borrowing by households and non-financial corporates

- Banks still key in transmitting financial shocks, especially in arm's length financial systems

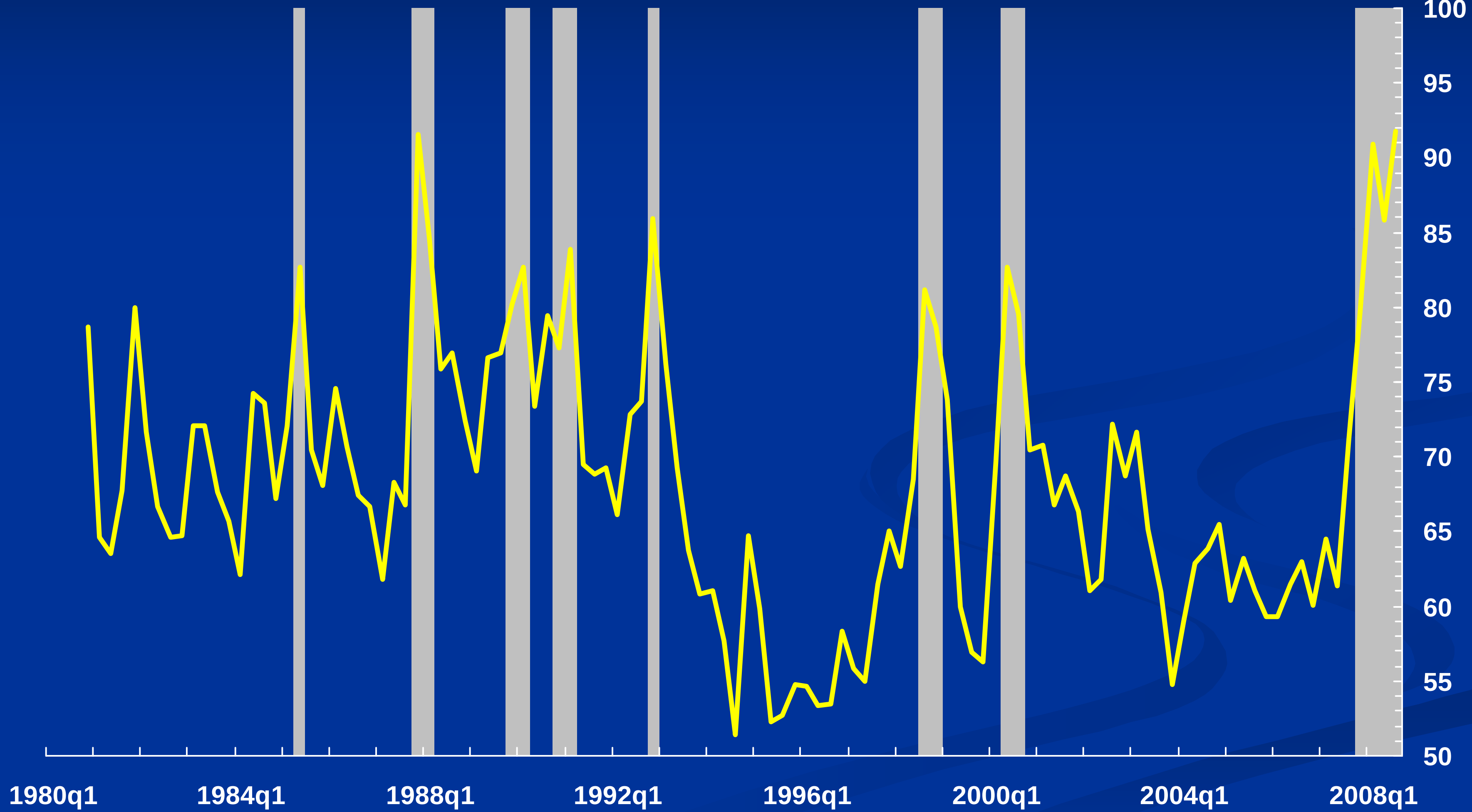
- Current conjuncture bears some resemblance to previous episodes of banking-related financial stress episodes that were followed by recessions

Example: FSI for United States



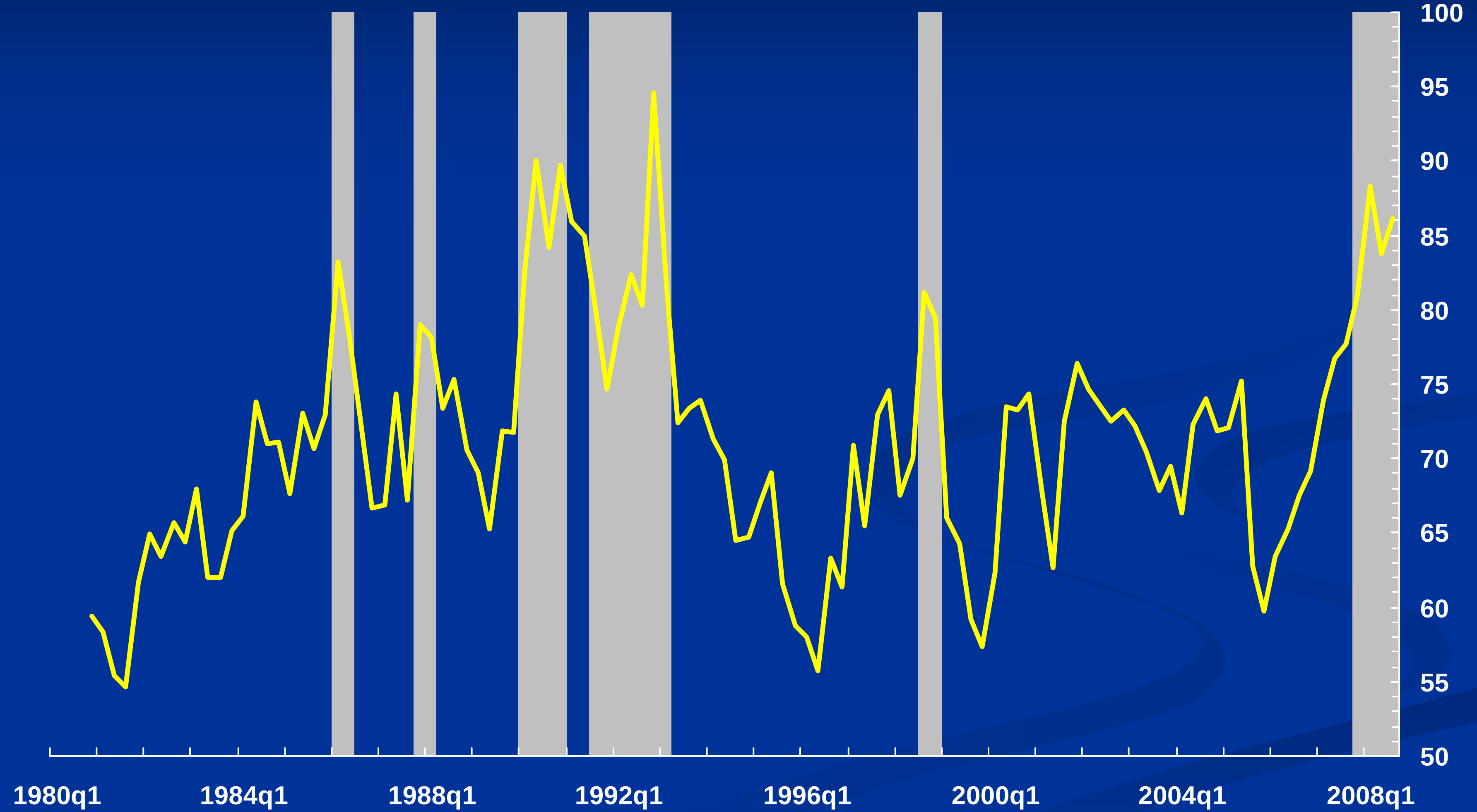
Note: Shaded areas indicate periods of financial stress.

Example: FSI for United Kingdom



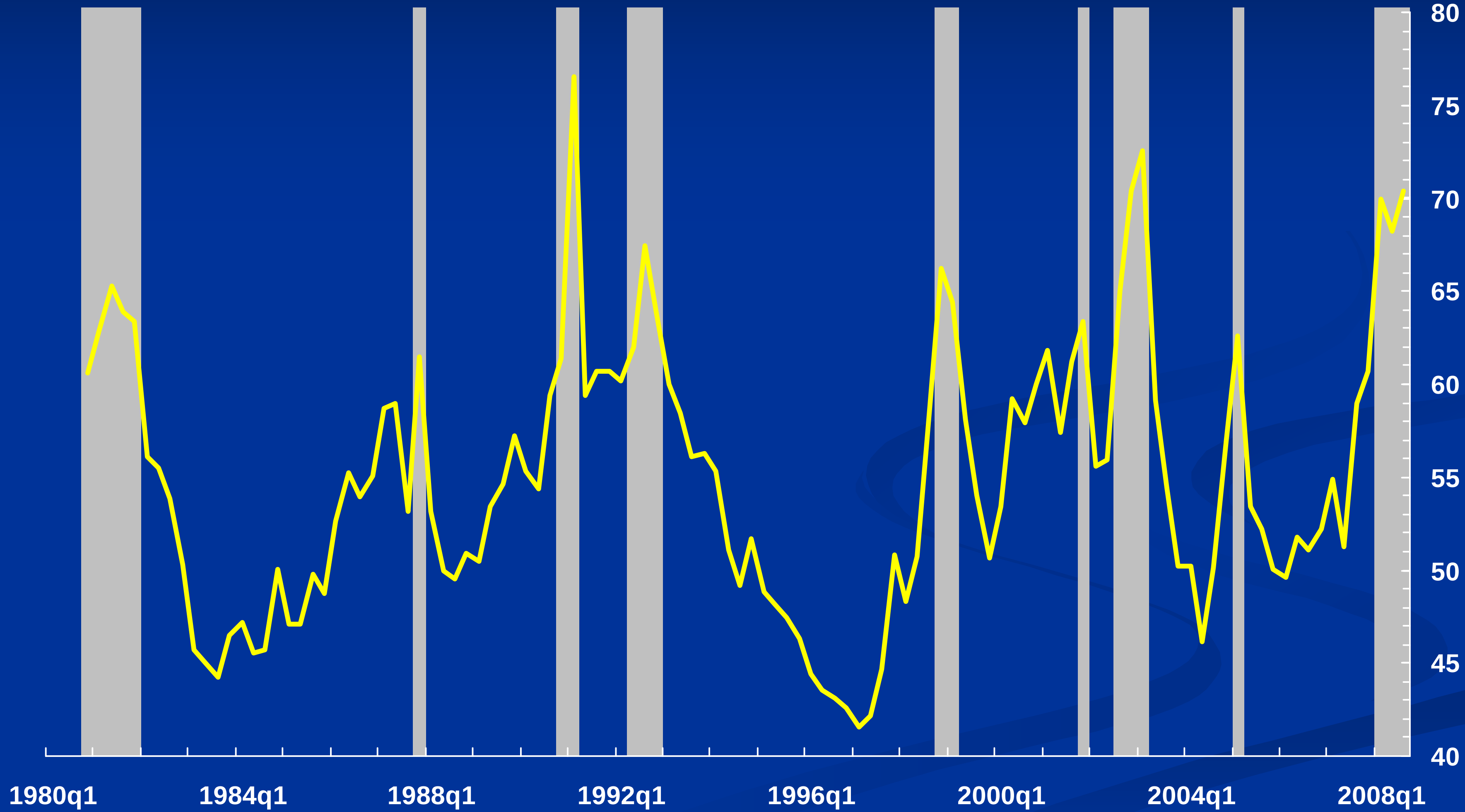
Note: Shaded areas indicate periods of financial stress.

Example: FSI for Japan



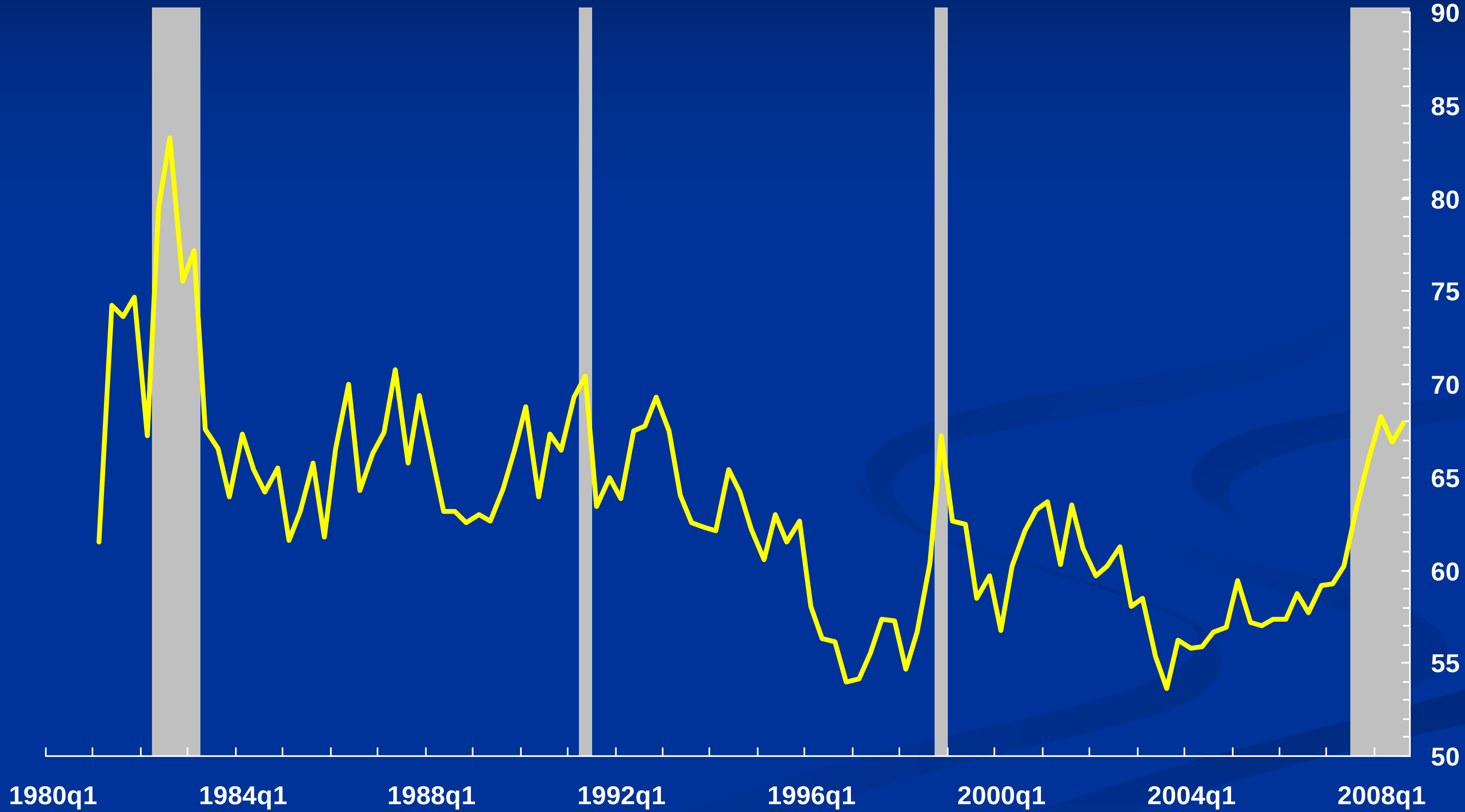
Note: Shaded areas indicate periods of financial stress.

Example: FSI for Germany



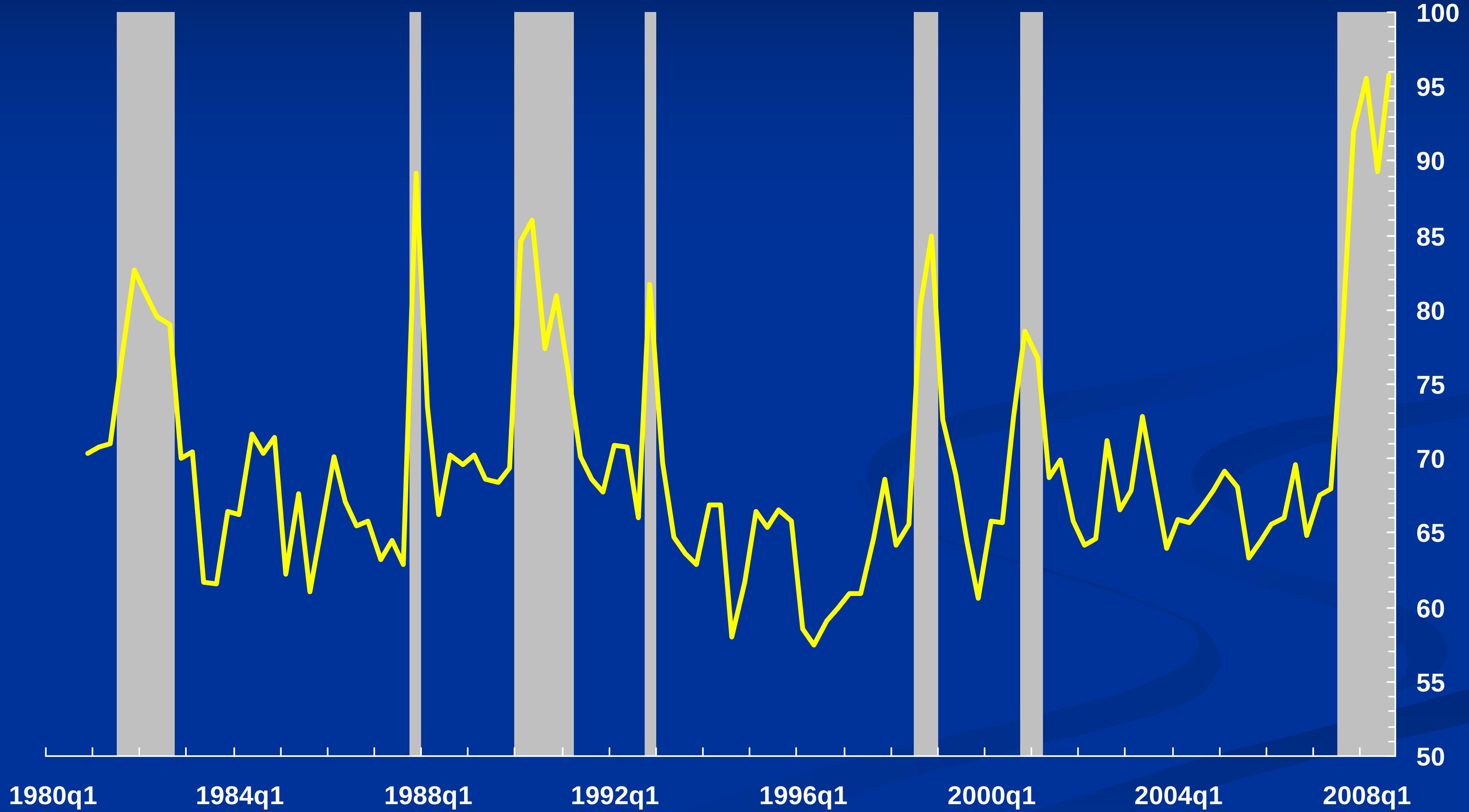
Note: Shaded areas indicate periods of financial stress.

Example: FSI for France



Note: Shaded areas indicate periods of financial stress.

Example: FSI for Canada



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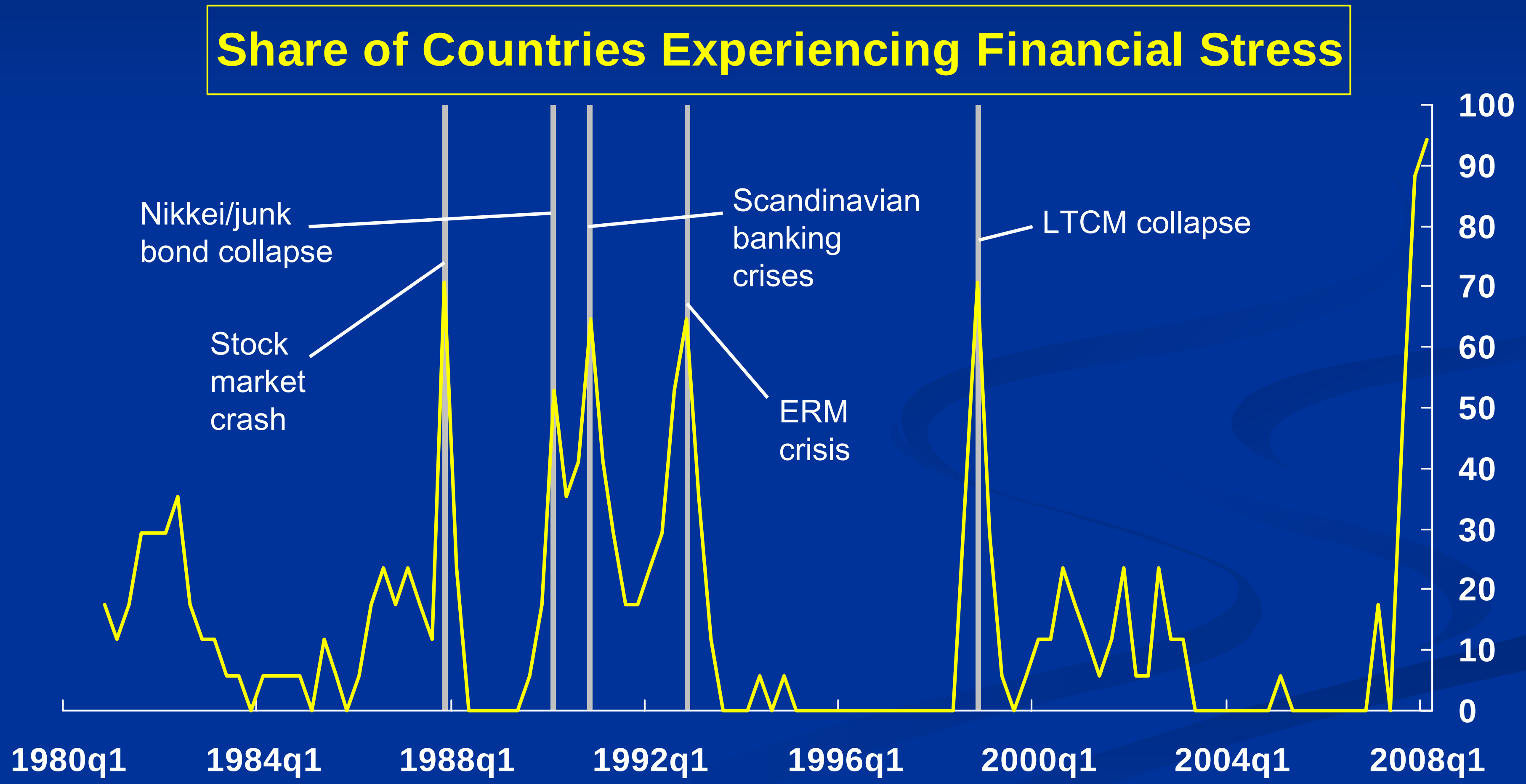
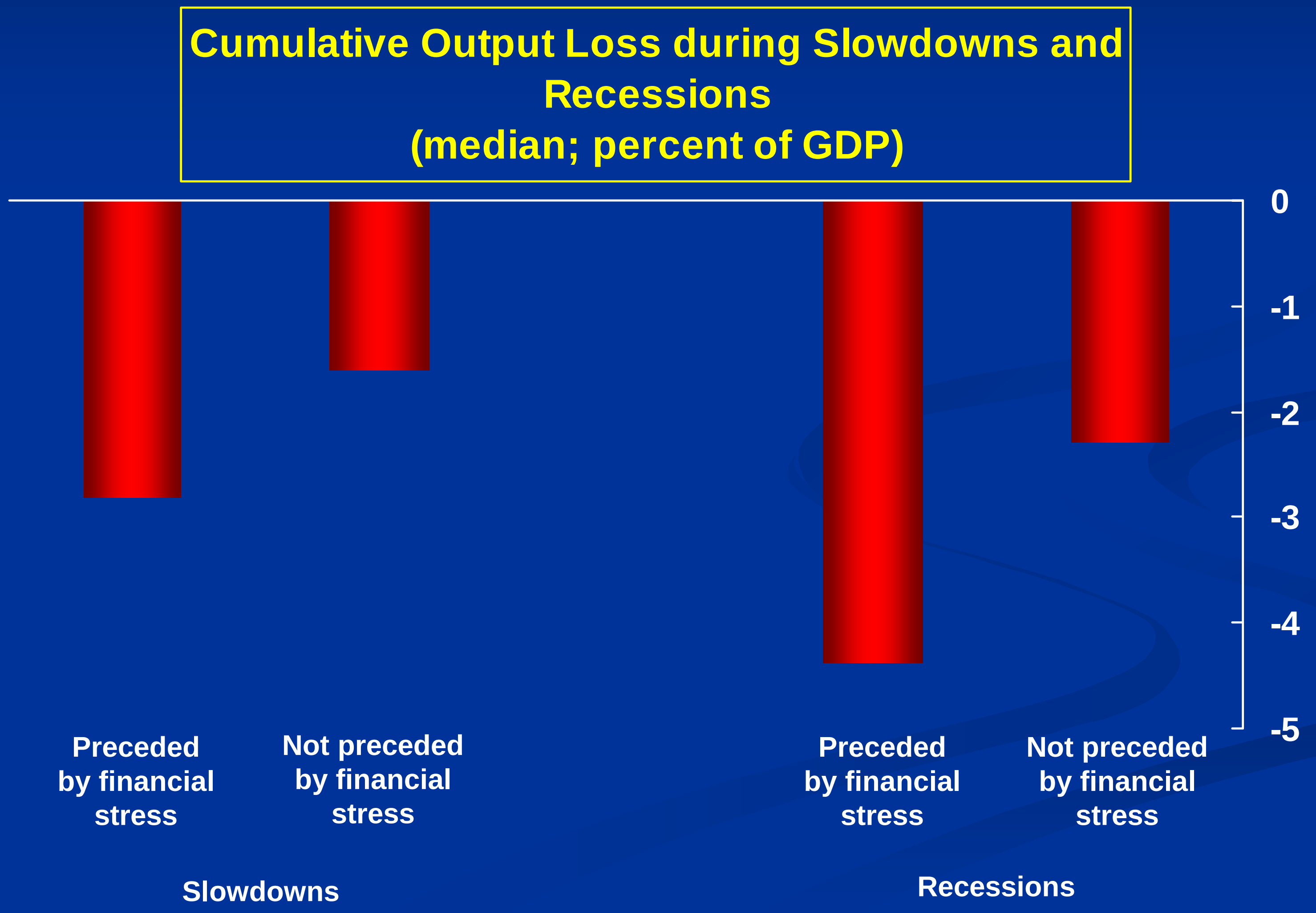
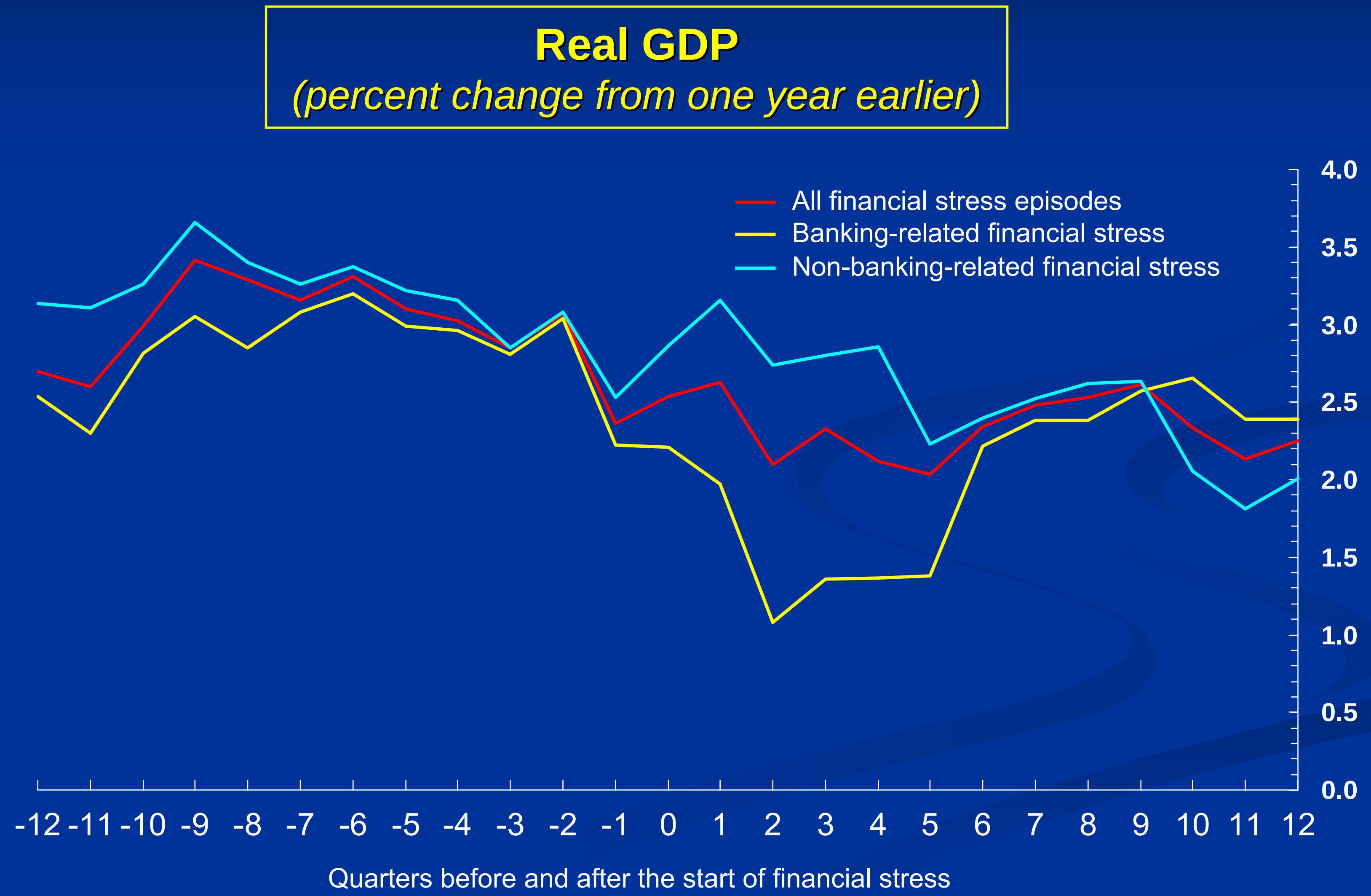
Main global financial stress episodes are captured by FSI



Economic downturns tend to be more severe when preceded by financial stress...

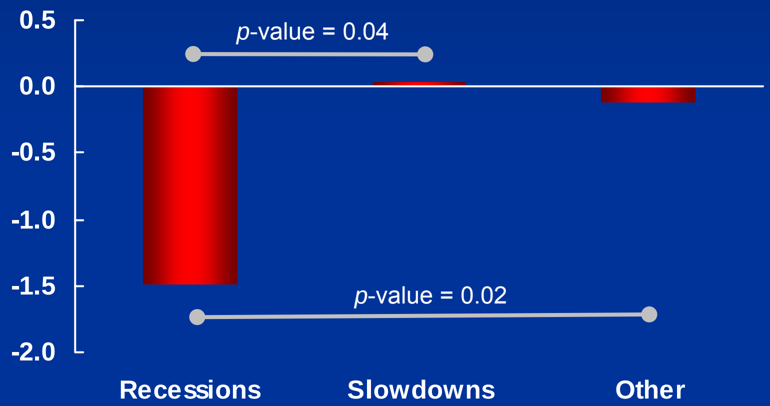


Banking system stress is associated with larger output consequences

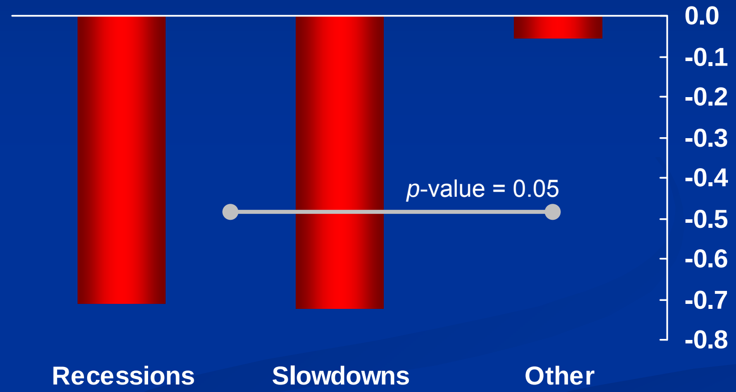


Downturns more likely with financial imbalances and large corporate borrowing

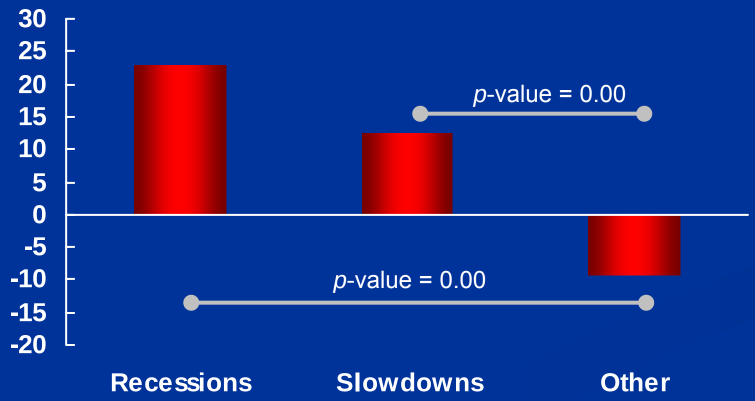
Household Net Lending/Borrowing (percent of gross disposable income; deviation from trend one year before start of financial stress)



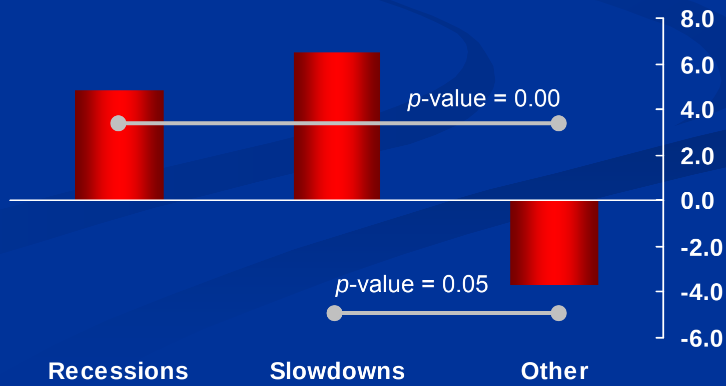
Nonfinancial Corporate Net Lending/Borrowing (percent of GDP; deviation from trend one year before start of financial stress)



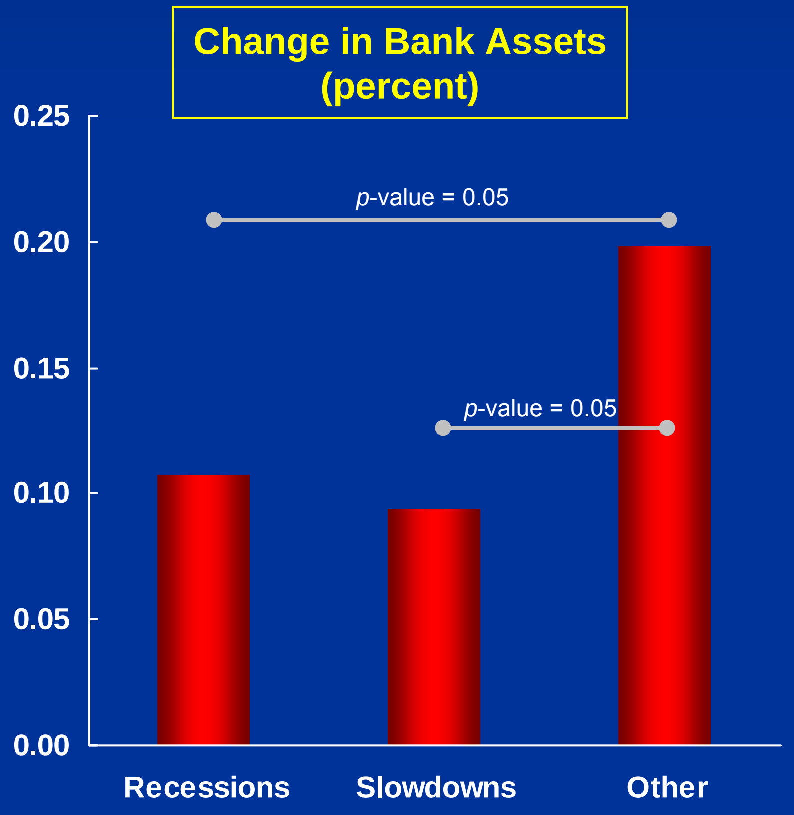
Real House Prices (cumulative percent deviation from trend over six quarters before start of financial stress)

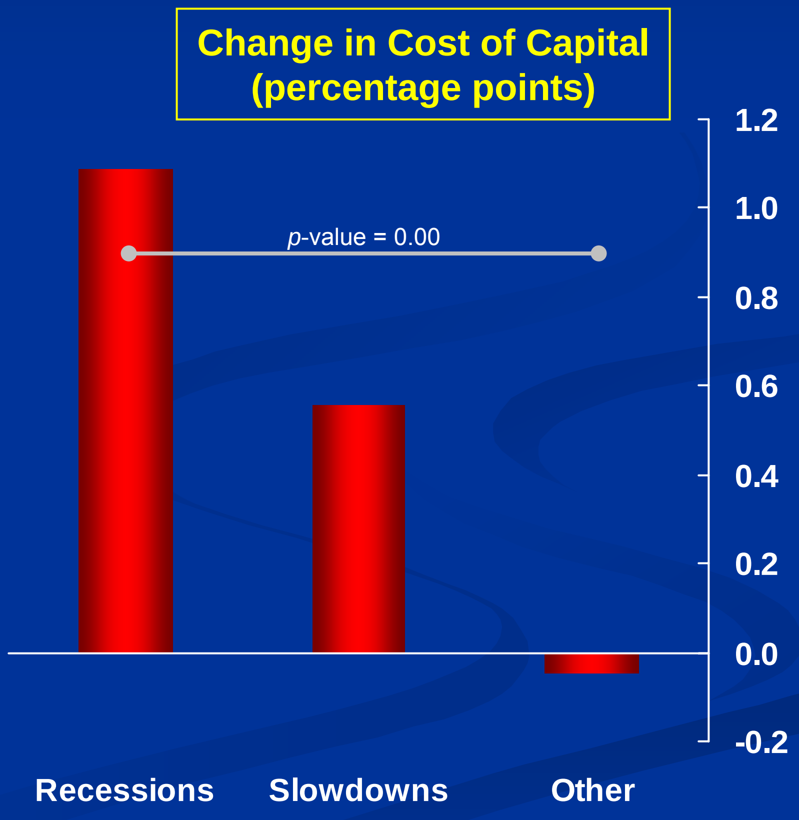


Credit (percent of GDP; cumulative percent deviation from trend over six quarters before start of financial stress)

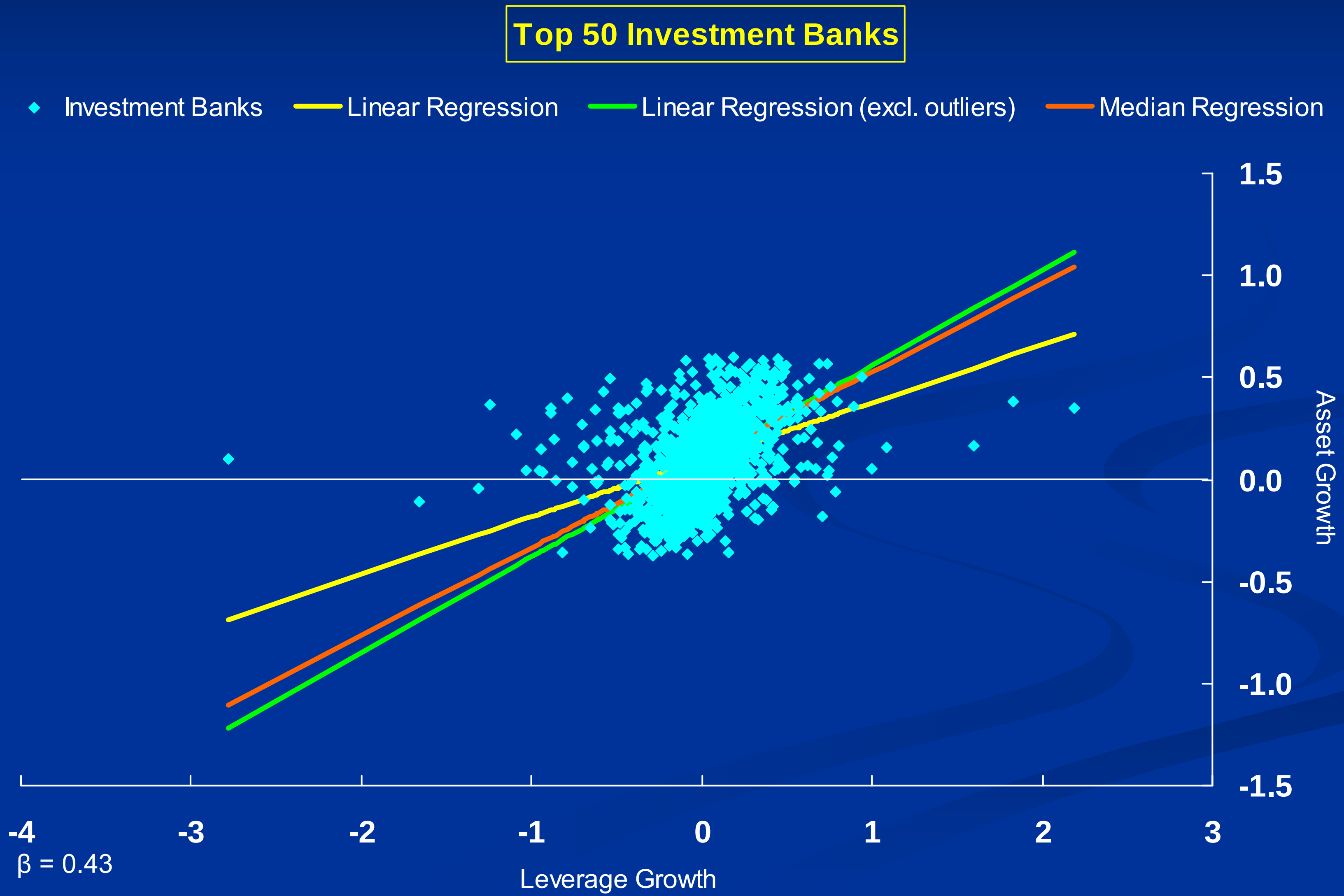


Evidence of "credit crunch" in banking-related recessions

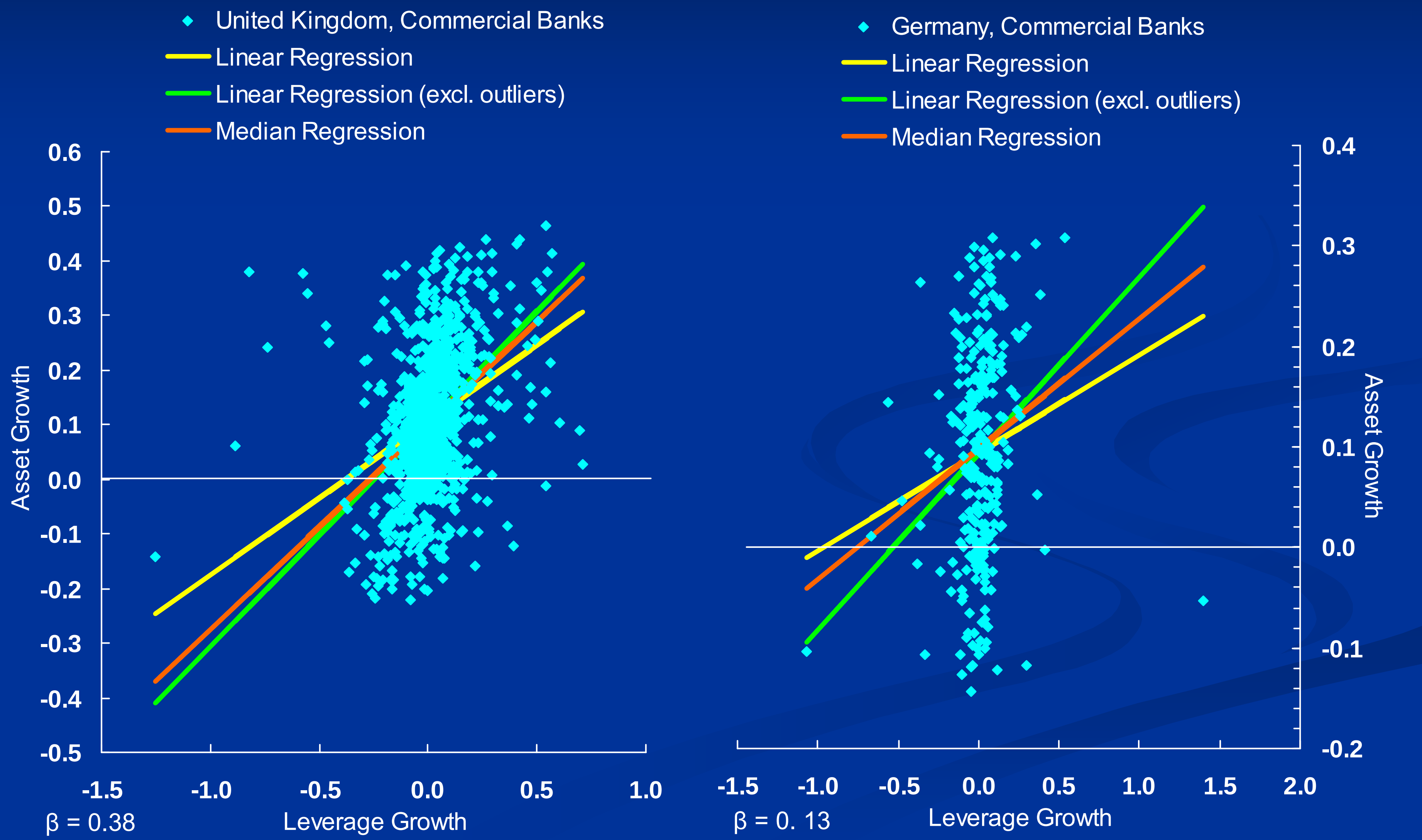




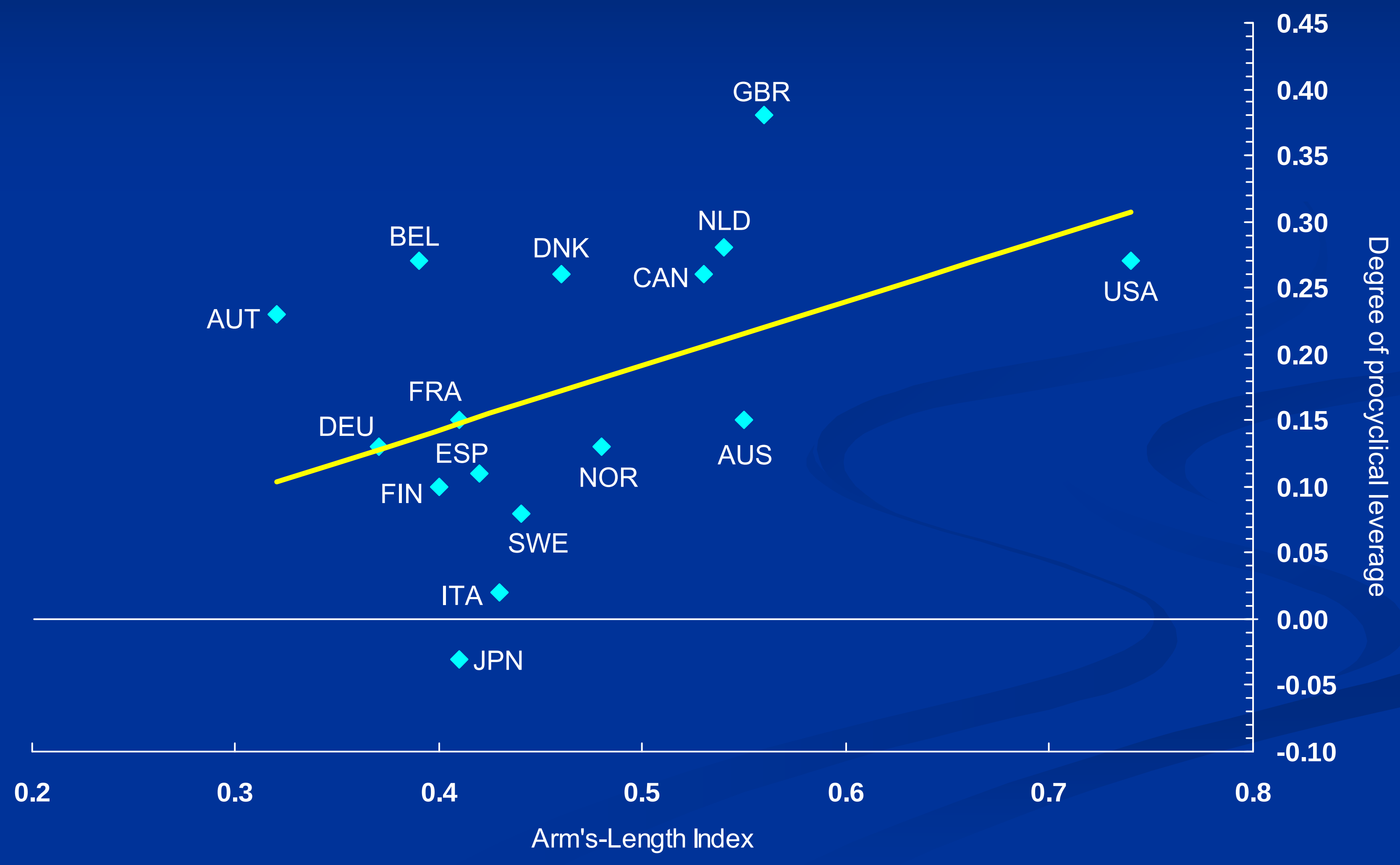
Investment banks' leverage is procyclical



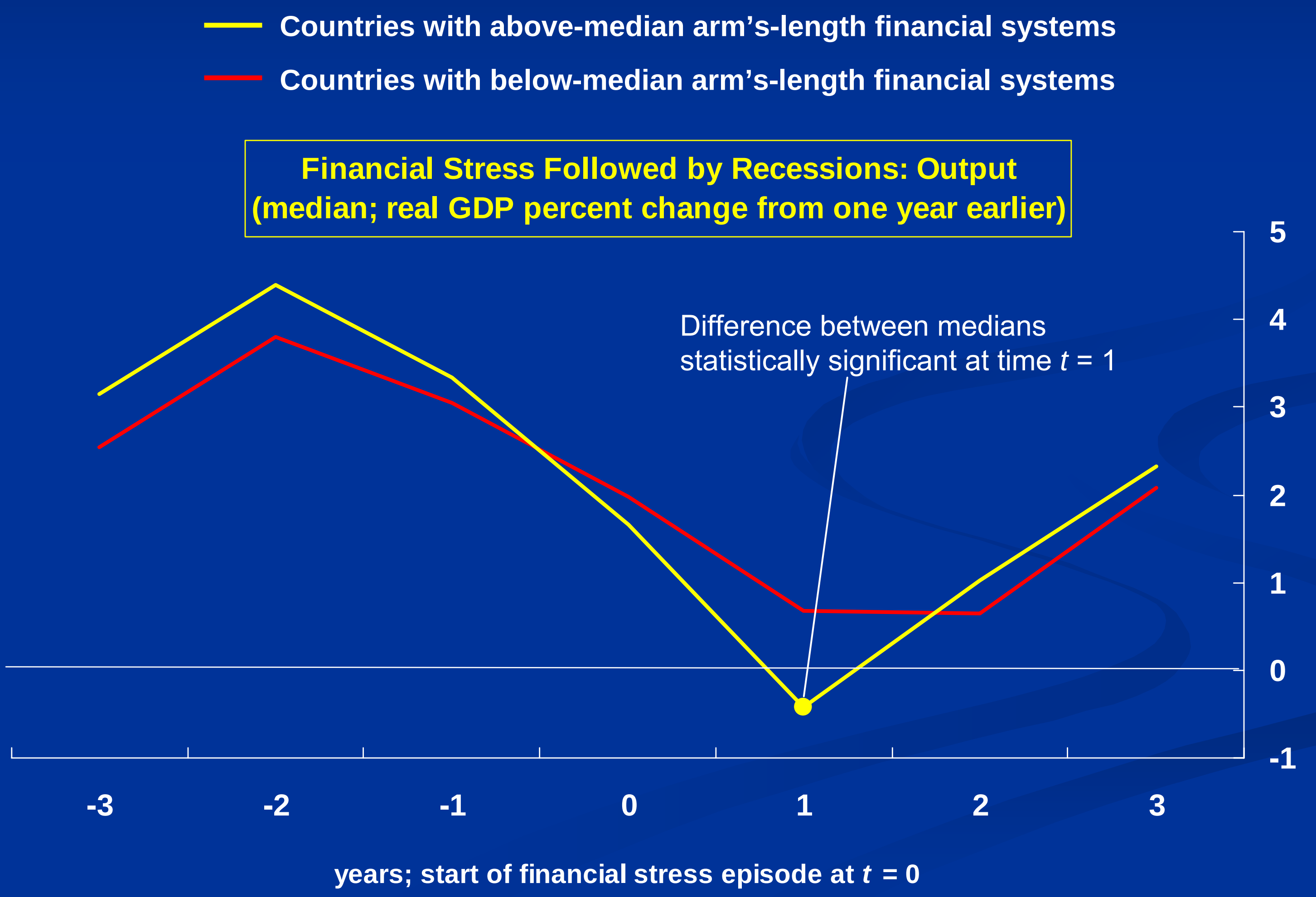
...while for commercial banks evidence is mixed



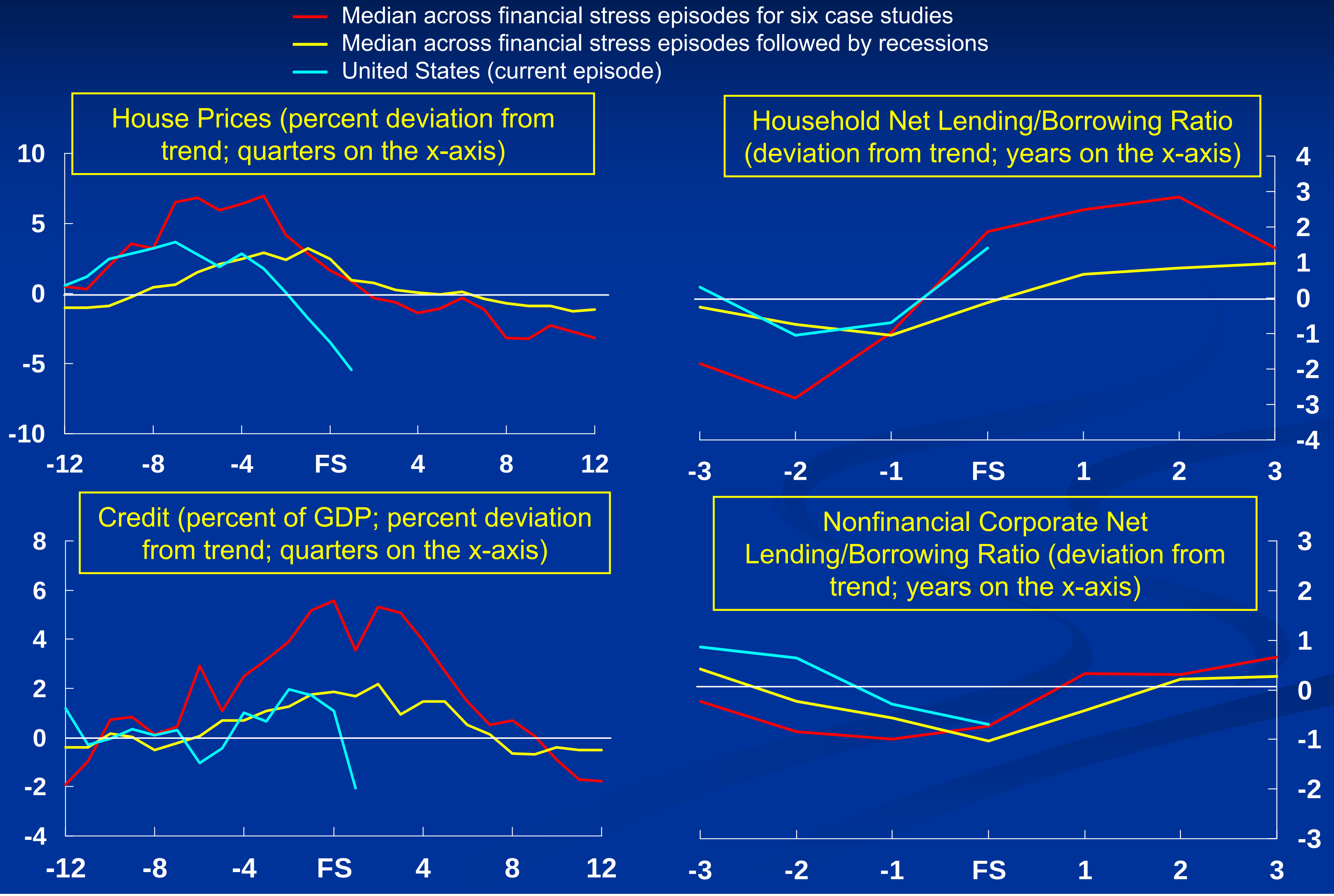
More evidence of procyclical leverage in arm's-length financial systems...



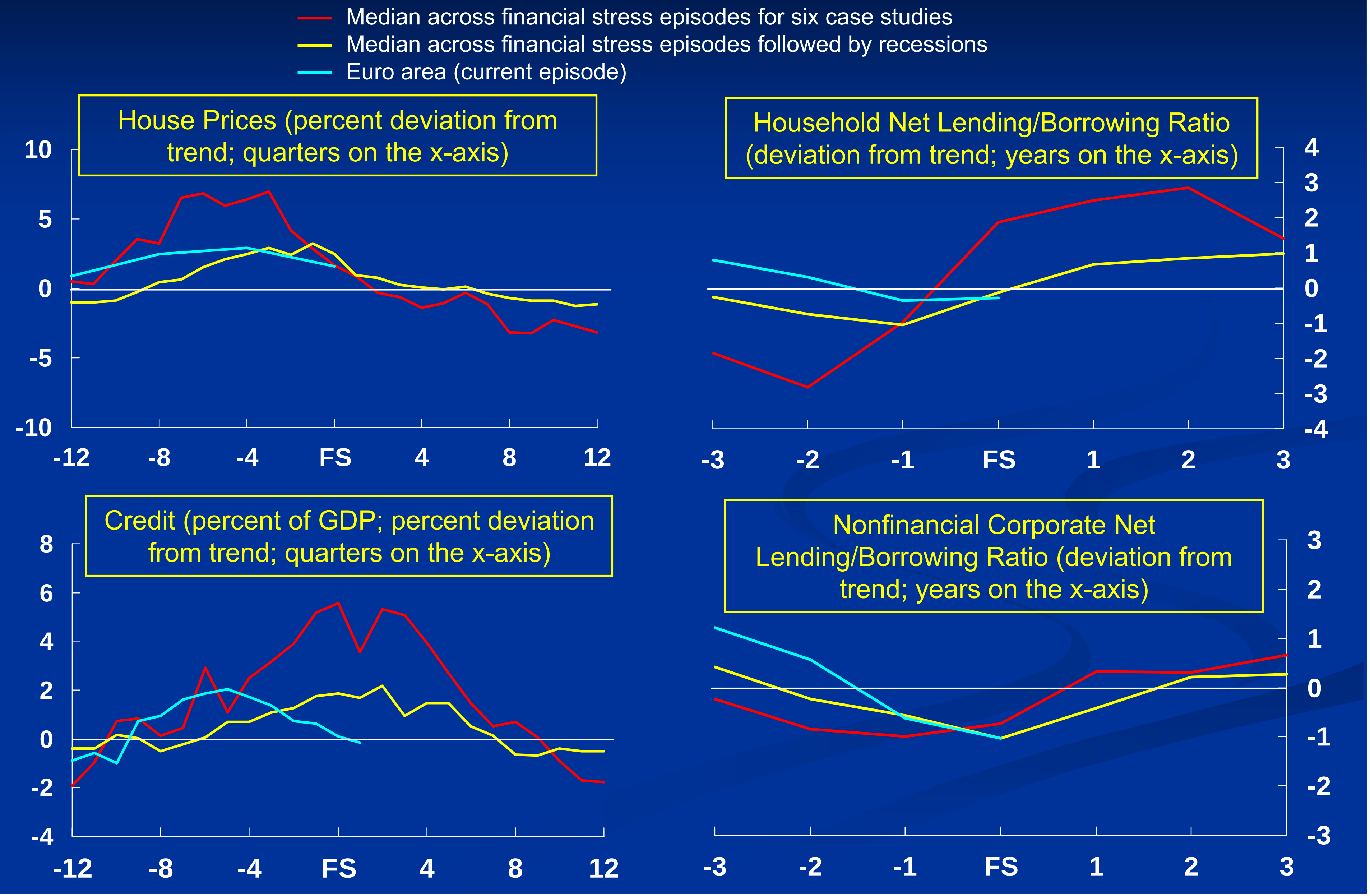
...which may explain larger real spillovers from financial crises in these economies



The Current Episode in Historical Context: United States



The Current Episode in Historical Context: Euro area



Policy Message

- One important take-away from this analysis is the importance of core financial intermediaries in the transmission of financial shocks to the real economy.

- This underlines the importance of restoring the capital bases of these institutions to help alleviate economic downturns.