**Press Points for Chapter 4: *Financial Stress and Economic Downturns***

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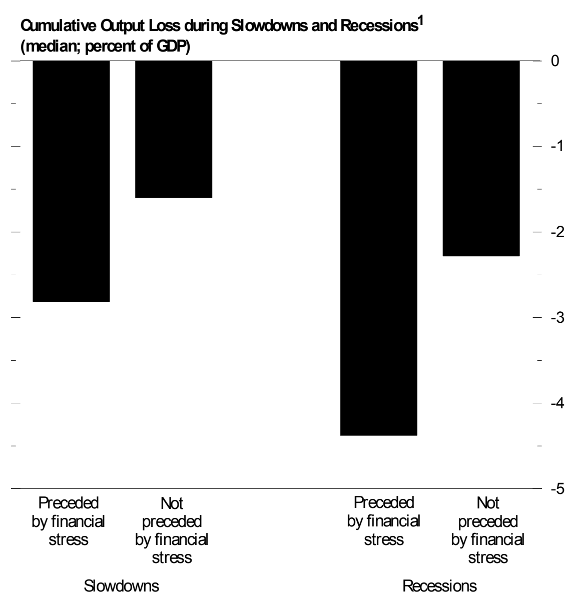
**Key Points**

- **Episodes of financial turmoil characterized by banking sector distress are more likely to be associated with severe and protracted downturns.**
- **Financial stress is more likely to be followed by an economic downturn when it is preceded by a rapid expansion of credit, a run-up in house prices and heavy borrowing by households and non-financial firms.**
- **The current situation of the United States bears some resemblance to previous episodes of banking-related financial stress episodes that were followed by recessions.**

**Chapter 4 of the WEO looks at past episodes of financial stress and their implications for subsequent economic activity.** The chapter constructs an index of financial stress in banking, securities, and foreign exchange markets in 17 advanced economies over the past 30 years, identifying 113 episodes of financial stress. Of these, about one-half are identified as banking-related, while in the remainder the stress is mainly concentrated in securities or foreign exchange markets. Based on this metric, the current episode of financial stress ranks as one of the most intense for the United States and one of the most widespread, affecting virtually all countries in the sample.

**Financial Stress and Output Loss**




Sources: Haver Analytics; OECD, Analytic Database; OECD, *Economic Outlook* (2008); and IMF staff calculations.
[1] Measured as the cumulative output loss when output was below the Hodrick-Prescott trend for slowdowns and cumulative output loss until recovery for recessions.

**Looking at these episodes reveals that not all episodes of financial stress lead to economic slowdowns or recessions**. In fact, this has only happened in around half of the episodes that were identified.

**However, when a slowdown or recession is preceded by financial stress, and especially when the stress is concentrated in the banking sector, typically it is substantially more severe than slowdowns or recessions not preceded by financial stress**. In particular, slowdowns or recessions preceded by bank-related stress tend to involve 2–3 times greater cumulative output losses and tend to endure 2–4 times as long.

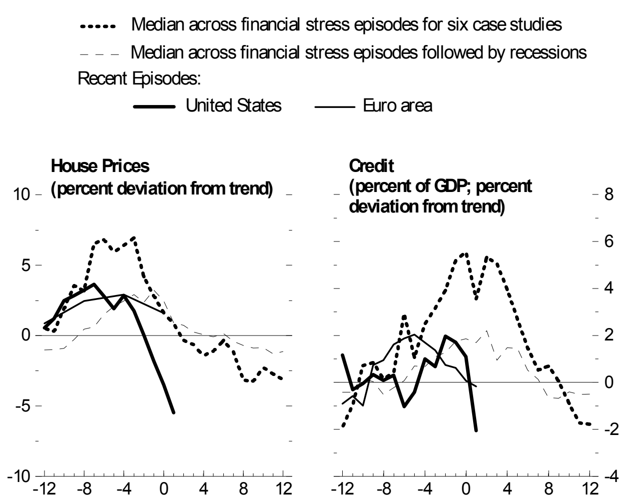
**What determines whether an episode of banking-related financial stress is followed by a slowdown or recession? The chapter suggests that initial conditions are crucial.** In particular, the likelihood that financial stress will be followed by a downturn is associated with the extent to which house prices and aggregate credit have risen prior to the stress episode. Moreover, while greater reliance on borrowing by non-financial corporations is associated with a sharper downturn in the aftermath of financial stress, the size of financial imbalances in the household sector is crucial in determining whether the downturn will turn into a recession. .

**The chapter finds that the development of more arms-length financial systems has increased the vulnerability to sharp contractions in activity if and when banking stress strikes.** Indeed, activity tends to be weaker in recessions preceded by financial stress in countries with more arms-length financial systems. This is because leverage in banking systems, defined as assets as a ratio to equity, appears to be more pro-cyclical in countries that have progressed further in terms of development of market-based financial intermediation. However, this does not imply that arm's length financial system are more prone to stress.

**Based on a comparison of the current episode of financial stress to previous episodes, there remains a substantial likelihood of a sharp downturn in the United States**. The patterns of asset prices, aggregate credit and household net borrowing in the United States during the current episode of financial stress appear similar to those of previous episodes that were followed by recessions. Offsetting factors that may provide some resilience are the relatively strong positions of corporate balance sheets at the onset of the crisis and the aggressive monetary easing by the Federal Reserve. In the euro area, the relatively strong balance sheets of households offer some protection against a sharp downturn, notwithstanding the sizable increases of asset prices and credit ratios preceding the financial turmoil.

**The Current Financial Stress Episode in the United States and Euro Area in Historical Context**[1]

*(Start of financial stress episode at* t *= 0; x-axis in quarters)*




Sources: European Central Bank; Haver Analytics; IMF, International Financial Statistics database; OECD, Analytic Database; OECD, *Economic Outlook* (2008); and IMF staff calculations.

[1]All in real terms.

**In these circumstances, strong actions by policy makers to deal with the stress and support the restoration of financial system capital seem particularly important**. One important take-away from this analysis is the importance of core financial intermediaries, including broker-dealers and investment banks, 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.