What Happens During Recessions, Crunches, and Busts?

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Comments on:

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Stijn Claessens, Ayhan Kose, and Marco Terrones

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“What Happens During Recessions, Crunches, and Busts”

- Comprehensive, well-researched, sophisticated addition to literature on business cycles, real/financial interactions
Builds, inter alia, on previous work by IMF staff


“What Happens During Recessions, Crunches, and Busts”

- Focus on building up stylized facts of interactions between real and financial sectors
  - To help us understand what’s occurring at present
  - Provide solid basis for future research
Key results:

1. International synchronization:
   - GDP growth
   - House prices
   - Equity prices
   - Credit

Current crisis is extraordinary, but we’ve seen this stuff before.
2. Clearly indicates how economic activity changes during periods of marked declines in credit, house prices, and equity prices.
Key results:

3. Focusing just on recession episodes:

- Recessions associated with credit crunches, housing busts, and equity prices are deeper than those without such events.
- Results weaker for equity price busts.
• Plausible results

• Confirm conventional wisdom
Questions that need addressing:

1. What does it mean to speak of recessions “associated with” credit crunches, housing busts, or equity busts ....

... when everything depends on everything else in general equilibrium?
House Prices ➔ Wealth ➔ Cons. ➔ GDP

Equity prices ➔ Credit Demand ➔ Resid. Invest. ➔ Business Invest.

Credit Supply ➔ Credit ➔ Business Invest.
• How can we distinguish a recession associated with a house price bust from one associated with a credit crunch?
House Prices

Equity prices

Wealth

GDP

Cons.

Resid. Invest.

Credit

Credit Demand

Credit Supply

Business Invest.
• How can we tell whether downturns in asset and credit markets are the cause or consequence of recessions?
Authors are clear they’re not trying to identify causal relations.

But they do try to categorize recessions and solve endogeneity problems by looking at timing:

- If fall in credit, house prices, or asset prices precede fall in output...
- ... recession is “associated” with that fall.
United States: 1973-74 Recession

- **Real GDP**

- **Real Policy Interest Rate**

- **Real Credit**

- **Real Equity Price and Real House Price**
Bottom line:

- Main drivers of a recession not necessarily the factors that move first.
• In categorizing recessions,
  - Determine if they substantially overlap with asset price declines or credit crunches
  - Don’t worry about which comes first
Questions that need addressing:

2. Are movements in credit aggregates the best way to identify periods of credit market distress?
Semantics:

- **Credit crunch**: sharp cutback in supply of credit
- **Shocks to credit markets can come from either supply or demand**
Demand for credit in part derived from demand for investment and consumption.

Not clear that changes in actual credit are reflecting credit market events rather than shocks to economic activity.
Recent developments also suggest evolution of credit outstanding may be misleading indicator of distress in credit markets.
Interbank Spread over OIS (3-Month)

- Daily Dollar Libor - OIS
- Euro Libor - OIS
- Sterling Libor - OIS

Basis points

Jan | Mar | May | Jul | Sep | Nov | Jan | Mar | May | Jul | Sep
2007 | | | | | | 2008 | | | |
United Kingdom Loans*

Quarterly percent change, a.r.

Nonfinancial Corporations

Households

*Q3 data is staff estimate.
Bottom line:

- Movements in credit aggregates may not be a good indicator of stress in credit markets.
- Might be better to identify episodes of credit market stress with deeper underlying indicators.
Financial stress index

7 financial market indicators

- Bank stock beta
- TED spread
- Slope of yield curve
- Corporate bond spread
- Stock market return
- Stock market volatility
- Exchange rate volatility
Figure 4.2. Financial Stress Index
(Shaded areas denote financial stress episodes)

The financial stress index appears to capture the current episode of financial stress in all countries in the sample.
Conclusion

- Well-researched paper
- Meticulous econometric methodology
- Useful insights and findings