Press Points for Chapter 4: *How Do Financial Systems Affect Economic Cycles?*

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Key Points

- **Differences in financial systems among advanced economies affect the behavior of economic cycles.**

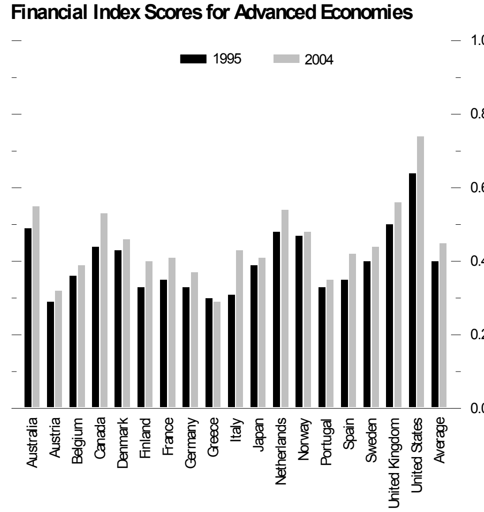
- **Households in so-called "arm's length" financial systems (including the United Kingdom and the United States) can borrow more to support consumption, but higher debt makes them more vulnerable to rising interest rates and declining asset prices.**

- **The more "relationship-based" financial systems in Europe are less well equipped to transfer resources from declining to growing economic sectors, thereby hampering efforts to boost productivity and respond to technological change and globalization.**

Chapter 4 of this World Economic Outlook presents new IMF research on the relationship between financial systems and economic cycles. The main conclusions are:

- **Financial systems in advanced economies are being transformed as a result of new technologies and deregulation, but there remain considerable differences across countries**. Based on a unique new index, the chapter finds that financial systems in Australia, Canada, the Netherlands, the United Kingdom, and the United States rely much more on arm's length transactions—where the parties involved have no special knowledge or information about each other that is not publicly available—than those in most of Europe and in Japan. These latter countries remain more reliant on longer-term borrower/lender relationships, despite an increase in the importance of arm's length transactions in recent years.

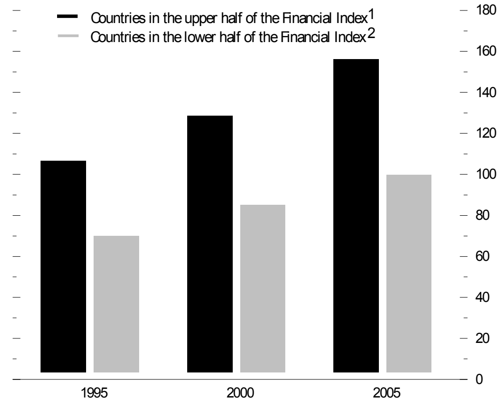
Financial Index Scores for Advanced Economies



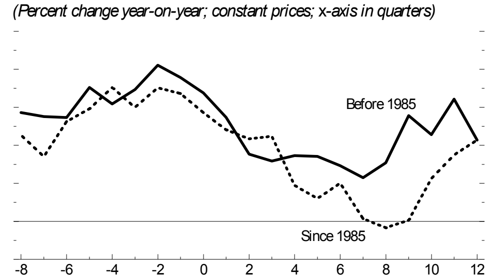
Sources: See Appendix 3.1 for sources used in the Financial Index.

- **Households in arm's length financial systems have easier access to borrowing to finance consumption spending, but are more vulnerable to asset price declines**. Well developed arm's length financial systems, such as those in the United Kingdom and the United States, enable households to borrow against the rising value of their homes, thereby boosting consumption and supporting strong economic growth. This, however, results in households having higher debt—an average of 160 percent of disposable income in 2005 in arm's length systems compared to less than a 100 percent in more relationship-based systems. Households in arm's length financial systems are therefore more vulnerable to rising interest rates and a downturn in asset prices. So, for example, during previous housing busts in countries with more arm's length financial systems, consumption growth typically slowed from an average of 3 percent (year-on-year) at the start of the bust to zero two years later. The slowing of the U.S. housing market is a key risk for the U.S. and global economic outlook.

Total Household Liabilities
(Ratio to disposable income; group average)



Private Consumption Response to Housing Busts, 1970–2005[3]
(Percent change year-on-year; constant prices; x-axis in quarters)



Sources: National financial accounts from Eurostat and OECD; OECD Analytic Database; and IMF staff calculations.
[1]Countries included are Australia, Canada, Denmark, Italy, the Netherlands, Norway, Sweden, the United Kingdom, and the United States.
[2]Countries included are Austria, Belgium, Finland, France, Germany, Greece, Japan, Portugal, and Spain.
[3]Countries included are Australia, Canada, Denmark, Italy, the Netherlands, Norway, Sweden, the United Kingdom, and the United States. Zero denotes the quarter after which a bust begins.

- **Financial systems that rely on relationship-based transactions are less effective than arm's length systems at responding to new growth opportunities opened up by technological innovation and globalization**. This is because the typical borrower/lender relationship tends to favor incumbent firms in existing industries, while arm's length systems are relatively unfettered by the constraints imposed by a longer term relationship with a borrower. Consequently, it is easier for them to reallocate resources from declining to growing industries, with substantial benefits for productivity growth. This is a particularly important finding for Europe, where labor productivity growth has lagged that in Australia, the United Kingdom, and the United States over the past decade.

- **Differences in financial systems may be one factor explaining existing global imbalances**. The financial system in the United States (as well as those in Australia and the United Kingdom) has enabled households to increase their borrowing to a much greater degree than in other countries, thereby pushing down saving and increasing the current account deficit. Sophisticated and liquid U.S. financial markets have also provided attractive investment opportunities for foreign savers, thereby helping to finance the U.S. deficit. For example, foreign investors account for around

10 percent of the $8 trillion mortgage backed security market in the United States. If other financial systems catch up to the United States, however, financing of imbalances is likely to become more difficult.

The chapter stresses that financial systems will continue to evolve, providing considerable economic benefits, but also posing challenges for policymakers. The chapter stresses the following three important policy conclusions:

- **Monetary policy**. With households using their assets, particularly housing, as collateral for borrowing, the impact of interest rate changes on asset prices is likely to become an increasingly important channel by which monetary policy affects the economy. As central bankers move to tighten monetary policy during this cycle, they will need to carefully assess whether rising interest rates are having a larger effect on household spending, particularly in countries that have moved furthest toward arm's length financial systems.

- **Regulatory and supervisory policies**. As financial systems change, risks will emerge in new areas, and it is important that financial regulators and supervisors adapt accordingly. For example, regulators need to be particularly vigilant to the consequences of the explosion of interest only and negative amortization mortgage loans in the United States.

- **The benefits of ongoing changes in financial systems will only be fully realized if supported by policy changes in other areas**. One of the key advantages of a more arm's length financial system is its ability to better reallocate resources from declining to growing sectors. This process needs to be supported by reforms that increase the flexibility of labor markets, including by improving the portability of pension and healthcare plans, and bankruptcy rules that ease the exit of unviable firms. Finally, strong, but well-defined, social safety nets would ensure adequate support for individuals and help in retraining for new employment opportunities.