Real consequences of financial crises

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Outline

- Real consequences of financial crises
  - Short-term: much is perhaps already known
  - Long-term: very little is known about impacts on potential
- How to go about assessing long-term potential?
- What are the policy implications?

Assessing impact on potential output

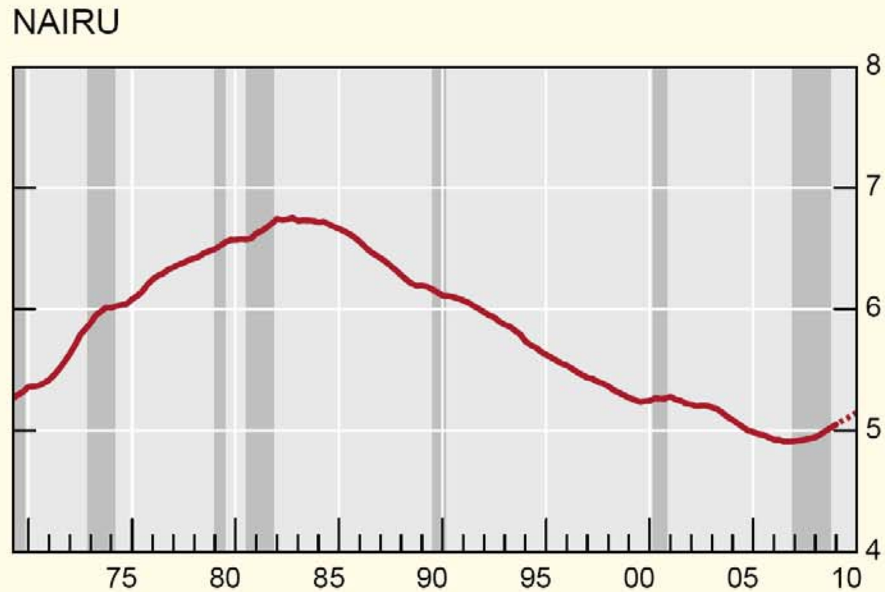
- Recession impact
- Permanent crisis impact
- Uncertainties stemming from data revision

Why might recessions have permanent effects?

- Certain shocks can shift potential output
  - Technology shocks change total factor productivity
  - Labour market shocks change hours and participation rate
  - Permanent terms of trade shocks (oil prices)
- Shocks can be persistent themselves:
  A sequence of large negative shocks
- Increases rigidities

… US recession labour market impact

US employment



Shaded areas refer to periods of recession dated by the NBER; for the current crisis, it's up to present.

[1] Civilian labour force participation rate, 16 years and over. [2] Permanent job losers as a percentage of total unemployed; 12-month moving average.

Sources: Datasream; OECD.

Do shocks have permanent output effects?

- GDP series contain a unit root

  Shocks have permanent effects on level
- Potential GDP series contain two unit roots

  Shocks have permanent effects on growth

	Australia	Japan	Finland	Norway	Sweden	UK	US
GDP	*Level*	*Level*	*Level*	*Level*	*Level*	*Level*	*Level*
Potential GDP	*Level*	*Growth*	*Level*	*Growth*	*Growth*	*Growth*	*Level*

Why might financial crises have permanent effects?

- By reducing credit and investment

  But credit could be endogenously driven by output

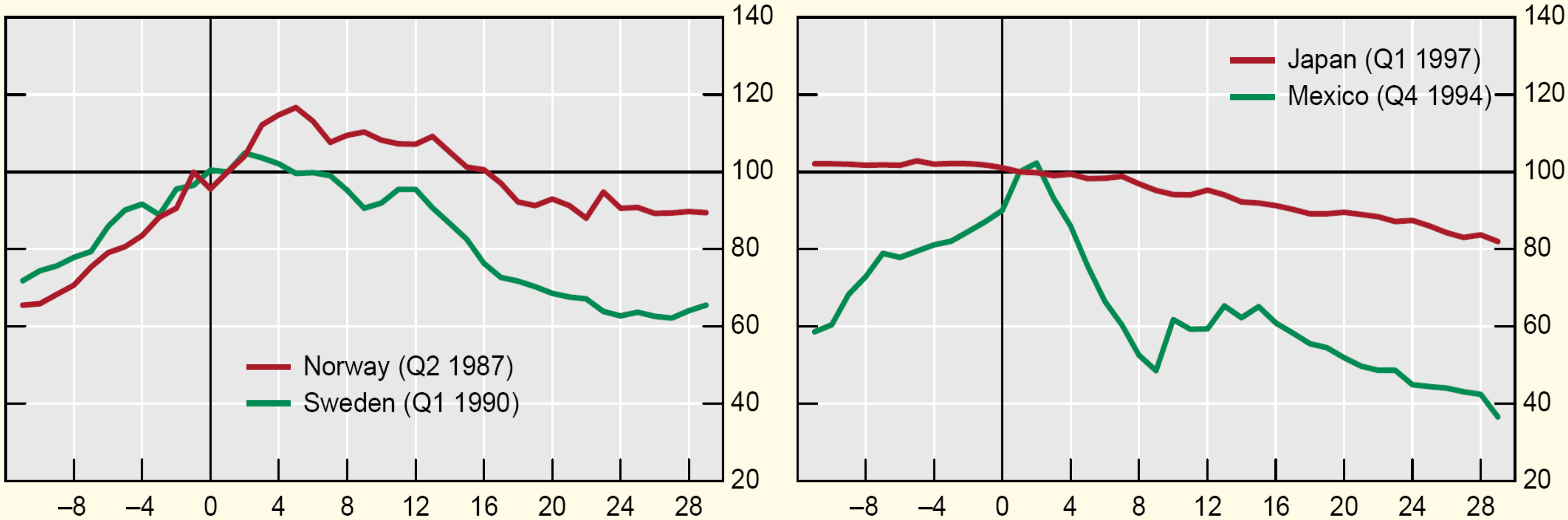
- By reducing total factor productivity
  (impairing ability of financial system to allocate capital)

  But it could also eliminate inefficient financial firms

Prolonged decline in credit to GDP ratio in previous financial crises

Private credit[1] from selected business cycles[2]

As a percentage of GDP



[1] Domestic credit to the private sector as a percentage of GDP, rebased on the peak of the business cycle. [2] Period zero and dates in the panel legends refer to the peak of the output cycle.

Sources: IMF; national data.

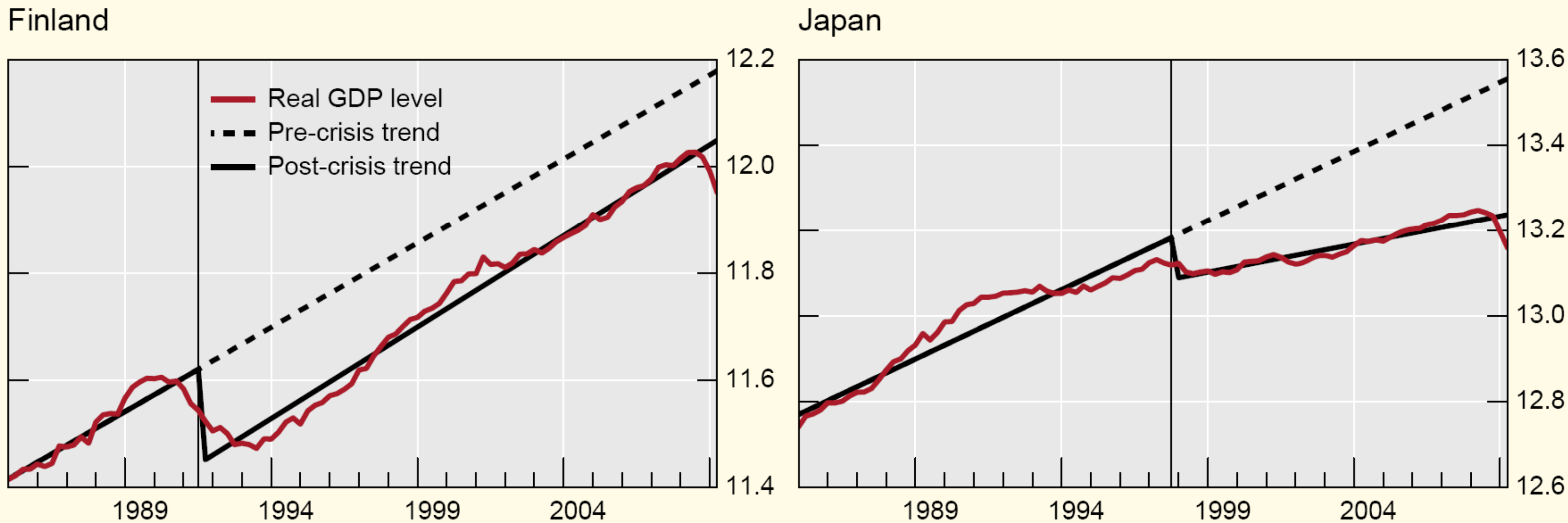
Evidence is mixed

- Credit to GDP ratio tends to fall following financial crises
- Impact on trend GDP is ambiguous
  - Negative impacts in Japan and Finland
  - But positive effects in Mexico and Norway

Negative Impact

Output from selected crises

In logarithm

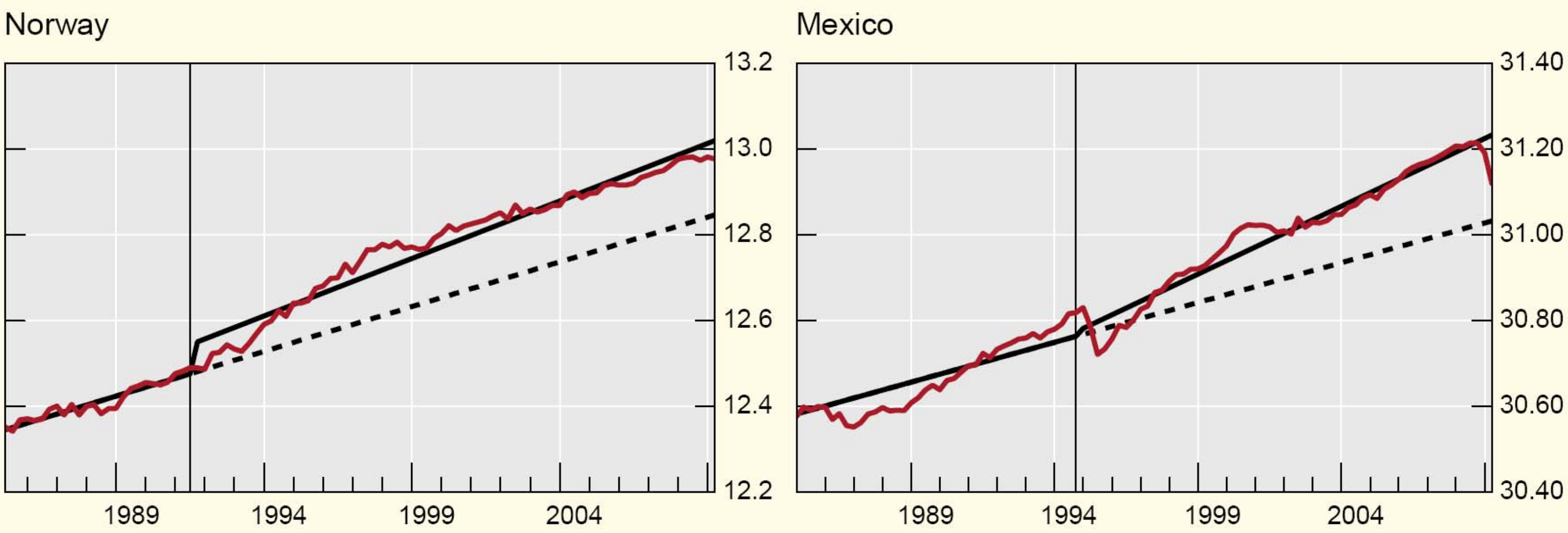


Source: BIS calculations

Positive impact

Output from selected crises

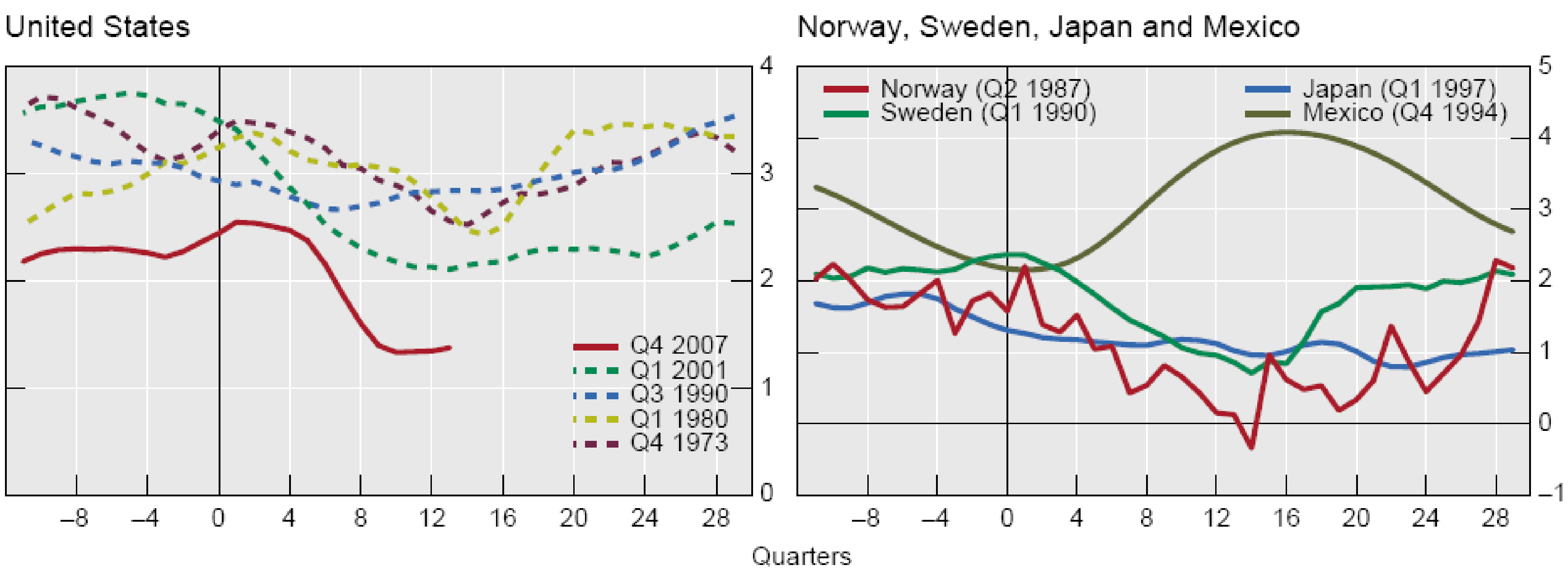
In logarithm



Source: BIS calculations

Potential output before & after crises

Potential output over selected business cycles[1]



[1] Annual changes, in per cent; period zero and dates in the panel legends refer to the peak of the output cycle; for the United States, peak dates are from the National Bureau of Economic Research (NBER).

Sources: OECD; national data; BIS calculations.

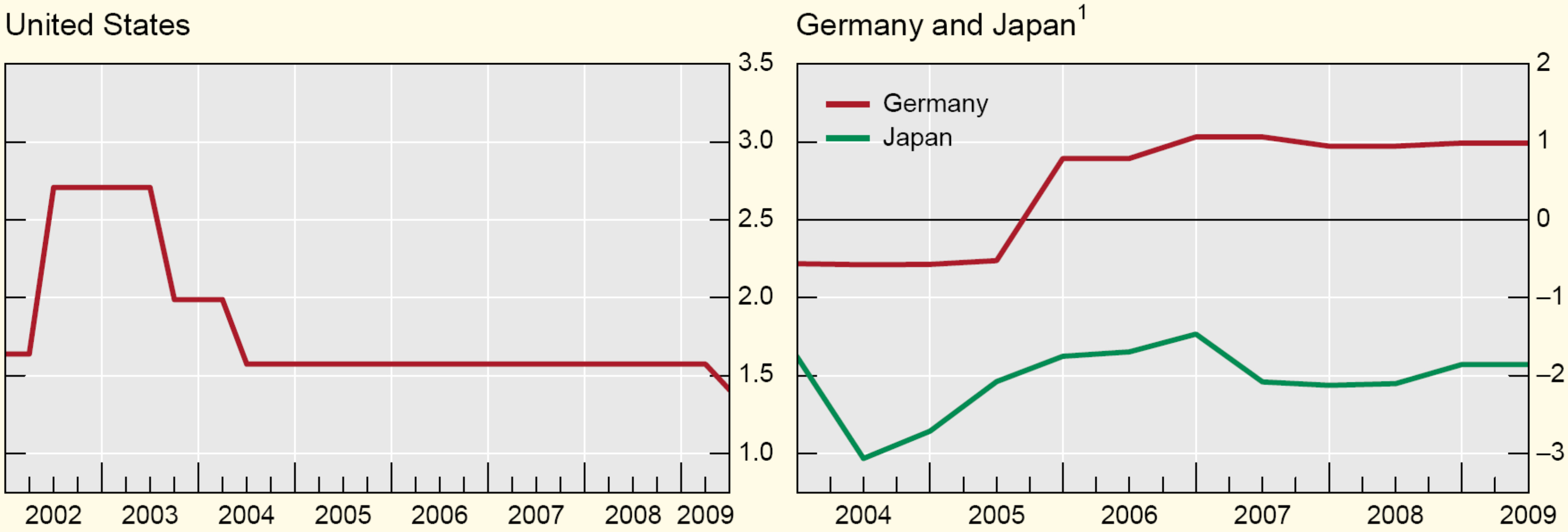
Challenges from real time data revision

- Frequent and large revisions of actual GDP
- Data revisions can reverse direction of growth
- Most revisions occur within three to four years

Examples of GDP revision

GDP data revisions for 2001 Q4

Annualised change, in percent



[1] Quarterly OECD vintage data started in Dec 2003.

Sources: Federal Reserve Bank of St. Louis; OECD.

Policy Implications

- Monetary Policy
  - Greater difficulties in assessing output gaps
  - Consequently natural rate of interest
- Fiscal policy
  - Uncertainty about structural budget deficits

Conclusions

- Difficult to differentiate financial crises effects from normal recession effects
- Impacts on long term supply is ambiguous
- Future evolution of potential output depends on policy actions