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Jonung, Lars

Published in:
European Economy News

2009

Document Version:
Förlagets slutgiltiga version

Link to publication

Citation for published version (APA):
Jonung, L. (2009). The financial crisis of today: a rerun of the past? *European Economy News*, (12).

Total number of authors:
1

The financial crisis of today: a rerun of the past?

The deep financial crisis of today has created an interest in the financial catastrophes of yesterday. Lars Jonung, Research Adviser at DG ECFIN, asks: is the present crisis a rerun of those of the past?

Lars Jonung

To answer, it is instructive to compare major recent crises with that of today. As demonstrated in the table, several financial crises have hit the world economy since the early 1990s. Of course, there are large differences across the countries shown in terms of size, political system, standards of living, etc. Still, all of them display roughly identical patterns of boom and bust as presented in a stylised manner in the figure below.

In short, the story is the following: the boom usually starts with financial deregulation and financial innovations combined with expansionary monetary and fiscal policies. The boom is driven by a rapid rise in credit and by low rates of interest. The rise in bank lending is channelled into asset markets, notably real estate and stocks. As real estate increases in price, the higher market value is used as collateral for new loans. The lending boom becomes a self-fulfilling process.

The general mood is one of optimism and risk-taking. Policy-makers, bankers and the public are not able to perceive the rising risks created in a financially vulnerable economy during the boom. Developments in the financial sector interact with the real economy. Consumption and investment, in particular in housing, rise rapidly. The whole economy is booming, that is, growing faster than the trend rate.

Eventually, the boom turns into a bust. Negative news changes the outlook from optimism to pessimism. Credit starts to contract. Interest rates rise sharply. The value of real estate and stocks falls. Wealth losses lead to lower consumption and investment and increase in private savings. Investment plummets, most rapidly within the construction sector. Unemployment soars. Tax revenues fall and public spending increases. The government budget deficit increases dramatically. The economy slides into a deep recession. At this stage, governments are usually forced to support the financial system with capital injections into banks and other measures to 'save' the financial system.

Major financial crises, 1992-2008

Country	Year
Finland, Sweden, UK	Autumn 1992
The ERM crisis	July 1993
Mexico	December 1995
Asia (Thailand, Indonesia, South Korea)	Summer 1997
Russia	August 1998
Brazil	January 1999
Turkey	May 2001
Argentina	December 2001
USA	August 2007
The world economy	2008

The above account describes the stylised boom-bust pattern of the 1990s. Yet the similarities with the recent crisis as it has developed in the US are striking. In the US, financial liberalisation and financial innovations fuelled the credit boom in the past ten years as they did in the crisis countries in the 1990s. Similarly, the expansion of lending originated in the housing sector, closely connected to the rise of sub-prime loans.

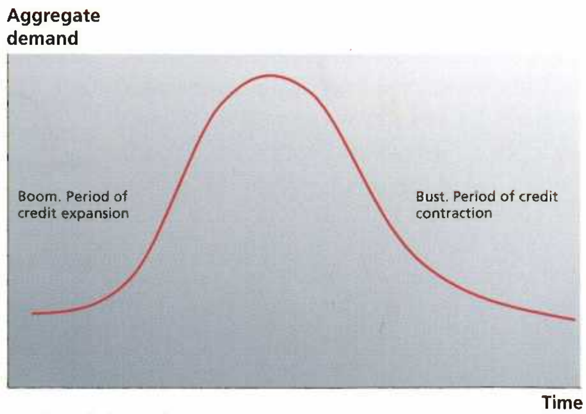
The high degree of financial innovations in the US made the country the centre of the recent financial storm by creating an extremely leveraged financial system. Structured products, sophisticated derivatives and a high degree of complex and opaque securitisation raised the extent of total US leverage. The outcome was excessive credit growth, excessive leverage and excessive funding that eventually turned into insolvency and panic when house prices stopped rising and the underlying model of refinancing broke down in 2006-2007. The boom turned into a bust in the summer of 2007, with a contraction of credit. Then it spread rapidly to the rest of the world.

As in the crises of the 1990s, the financial system was severely hit. Financial institutions in the US have been faltering on the brink of bankruptcy. The US government has been forced to step in with subsidies, financial support, outright ownership, etc. at enormous cost to the taxpayers. As in the 1990s, the budget deficit and public debt have soared in the US to unprecedented levels. Monetary policy in the US is now in an extremely expansionary phase as the authorities try to brake the economy's slide into deep recession.

Of course, there are significant differences between the present crisis and those of the 1990s. The current one, originating in the US, has turned into a global recession because the US economy is the biggest in the world. The crises of 1990s remained local or regional as they took place in smaller countries. In the 1990s, crisis-hit countries could rely upon the rest of the world to provide demand for exports. This is not the case today, which makes the present crisis more threatening. In addition, the deep globalisation of finance and trade has caused the crisis to spread faster and further than in the past.

Although financial crises are not exactly the same, the boom-bust pattern of the 1990s is repeating itself to a surprising extent in the United States at present, and the figure captures the basic crisis dynamics of today as well as yesterday. ■

The boom-bust pattern. A stylised view



Source: Commission services