Box 4

THE CURRENT MACROECONOMIC CYCLE: A COMPARISON WITH PREVIOUS BANKING CRISES

As the global financial crisis intensified and spread over the past year, the macroeconomic outlook in the euro area worsened significantly. One way of better understanding the possible impact of the financial turmoil on the real economy is to compare the amplitude and time profile of macroeconomic cycles (and patterns in macro-variables) with those observed during past episodes of banking crises.[1] With the inevitable caveats – including that no two financial crises or recessions are entirely alike – a comparison with earlier episodes provides some insight into the "common" or "average" path followed by economies facing significant financial dislocation.[2]

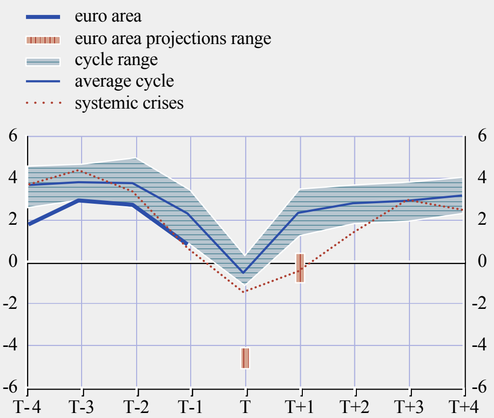
Charts A to D illustrate the evolution of certain macro-variables in various advanced economies during five systemic banking crises, namely Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). They also compare them with the average experience during other "normal" cycles (i.e. those downturns that occurred without financial turmoil) in 20 advanced economies. Clear differences in the depth and duration of the downturn can

1 For other studies on the evolution of macroeconomic indicators in countries experiencing banking crises, see C. Reinhart and K. Rogoff, "The aftermath of financial crises", *NBER Working Paper*, No w14656, National Bureau of Economic Reasearch, January 2009; and S. Claessens, M. A. Kose and M. E. Terrones, "What happens during recessions, crunches and busts?", *IMF Working Paper*, No 08/274, December 2008. For a discussion of leading macrofinancial indicators of financial turmoil, see Box 5 in ECB, *Financial Stability Review*, June 2008.

2 The caveats are not trivial. The comparisons average across countries, time and policy regime; the initial causes of the crises and policy responses differed. The same is true for other cycles.

Chart A Real GDP growth during banking crises and "normal" cycles

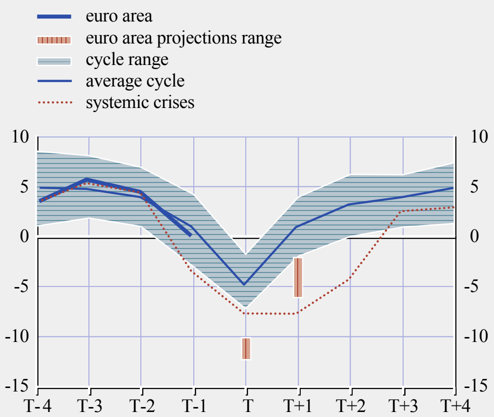
(percentage change per annum)



Sources: Eurostat, ECB, AMECO, IMF, European Commission and ECB calculations.
Notes: The "systemic crises" line shows the average profile of macro-variables during five systemic banking crises in advanced economies: Spain in 1977, Norway in 1987, Finland in 1991, Sweden in 1991 and Japan in 1992. In each case, period T represents the trough in GDP growth following the onset of a banking crisis. The "average cycle" line shows the mean path for variables across cycles in 20 advanced economies from the 1970s onwards. The "cycle range" shows the inter-quartile ranges of those cycles. The "euro area" line shows the recent experience in the euro area and the bars show projection ranges embodied in the ECB/Eurosystem staff macroeconomic projections for June 2009, where period T represents 2009.

Chart B Real investment growth during banking crises and "normal" cycles

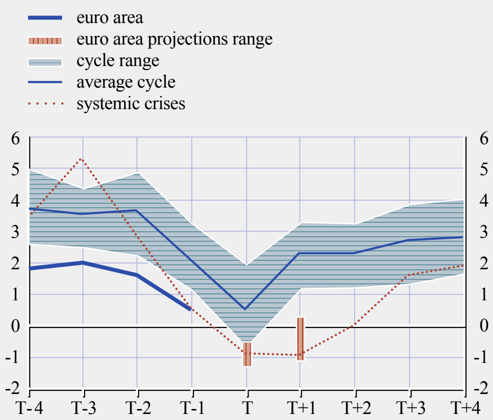
(percentage change per annum)



Sources: Eurostat, ECB, AMECO, IMF, European Commission and ECB calculations.
Notes: See notes to Chart A.

Chart C Real consumption during banking crises and "normal" cycles

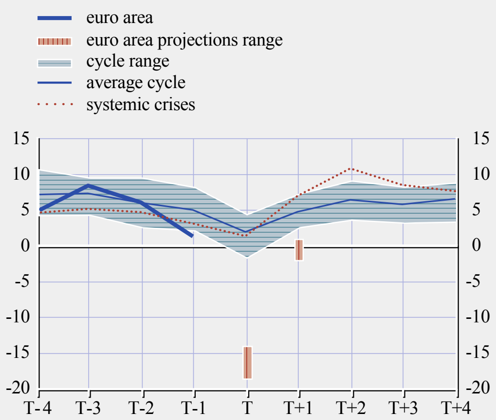
(percentage change per annum)



Sources: Eurostat, ECB, AMECO, IMF, European Commission and ECB calculations.
Notes: See Notes to Chart A.

Chart D Real exports during banking crises and "normal" cycles

(percentage change per annum)



Sources: Eurostat, ECB, AMECO, IMF, European Commission and ECB calculations.
Notes: See Notes to Chart A.

be observed: "normal" cycles display a sharp decline in activity growth followed by a swift recovery, which is represented by a pronounced "V" shape, while banking crises involve a more protracted, "U-shaped recession" (see Chart A). These differences are also apparent in the components of demand. Countries experiencing a banking crisis tend to undergo prolonged adjustment in investment (see Chart B), particularly in residential investment (which partly reflects strong declines in residential property prices). Compared with "normal" cycles, household consumption is also weaker (see Chart C). In part, this reflects the decline in household incomes – unemployment, for example, increased sharply during past banking crises. However, the moderation in consumption also reflects an increase in the proportion of income saved, as households possibly increased precautionary savings or attempted to repair their balance sheets. Finally, it appears that the impetus to growth from external demand is a considerably more important driver of recovery for countries coming out of a banking crisis (see Chart D). In some instances, this was driven by marked real exchange rate depreciation, but it was also because, in some cases, financial instability was country-specific: global growth remained relatively resilient and an export-led recovery was more possible.

The comparison with past banking crises provides a certain context for the recent and expected macroeconomic performance of the euro area. Reflecting the ongoing impact of the financial turmoil, projections for the euro area outlook by private sector forecasters and other international institutions have been revised down significantly in recent months.[3] Expectations are generally for a "U"-shaped recession, typical of periods of severe financial instability. The Eurosystem staff macroeconomic projections published in June 2009 also provided a central projection that was similar to the past experiences of economies undergoing significant adjustment in the financial sector.

3 See Chart 2.1.

However, compared with previous recessions, there were differences across the ECB/Eurosystem staff projections for demand components, which highlight some of the different ways in which the financial crisis has affected the euro area. While the projection included a prolonged fall in investment and muted consumption growth, the corresponding path for overall domestic demand was slightly higher than that observed in some of the previous crises. In part, that reflects the strong policy measures taken in response to the financial turmoil, which should eventually help to boost confidence and domestic demand. By contrast, the expected profile for exports was significantly more downbeat than in previous cycles. This reflects the rapid deterioration in the international environment, with a more synchronised slowdown across advanced and emerging economies than observed in the past.