Some lessons learned from earlier financial crises

So far the effects of the financial unrest on share prices and corporate bond rates have been less than during similar periods of financial turbulence. But it is too early to draw the conclusion from this that the effects on developments in the real economy will be limited. The risk of poorer development than in the main scenario is primarily linked to developments in the US housing market.

Since July, developments in the financial markets have been turbulent. These developments are linked to the problems in the US mortgage markets.

This box contains a comparison between the most recent financial unrest and four other periods of turbulence. One period compared is that following the stock market crash on 19 October 1987. Another period is from August 1998, when the rouble devaluated and the Russian state defaulted on its debt payments. This had considerable negative effects on, for instance the LTCM (Long-Term Capital Management) hedge fund. A comparison is also made with the IT crash in 2000 and the economic consequences of the terrorist attack against the World Trade Center on 11 September 2001.

The origins of these crises have differed. The financial unrest in 1998 followed in the wake of the widespread crisis in Asia, and the unrest in 2001 followed an exceptional event with political overtones. The turbulence in the financial markets in 1987 and 2000 originated in the United States, and this applies very much to the most recent period of unrest.

Common to all of these periods is a rapid increase in uncertainty and a lack of relevant information to assess the risks. In all cases this has led to a flight to safe assets, which has resulted in stock market falls and increased credit spreads.

Lesser fall on the stock market this time

Initially one can observe that stock market developments have so far been affected to a much lesser degree than during previous episodes (see Figure B1). In the stock market crash of 1987, for instance, the US stock market fell 20 per cent in one day. When the IT crash came the fall was not as rapid but on the other hand it extended over a longer period of time.

Less upturn in credit spreads

The differential between interest on corporate bonds and government bonds, known as the credit spread, has also been affected less than before. This applies regardless of the company's credit rating and regardless of which country is studied. The interest rates that have increased most during the current financial unrest are the rates companies with low credit ratings face, while the interest rates for companies with high credit ratings are virtually unaffected (see Figure B2). This pattern is similar to the earlier periods.

With regard to possible effects on the real economy from the turbulence, it is interesting to note that corporate bond rates are

currently very low, from an historical perspective. In addition, higher financing costs can be weighed against company balance sheets at the same time being particularly strong.

Larger upturn in the interbank market spread

The distinguishing feature of the most recent credit unrest is that the spread between short government securities and interbank rates has increased by a relatively large amount (see Figure B3). This applies to most durations.

The upturn in the TED spread, that is, the difference between a three-month interbank rate and the rate on a corresponding treasury bill, is primarily the result of increased interbank rates. This is a sign that the banks' credit risk has increased. If the problems remain, it may in the long run have negative consequences for the real economy, as other types of loans and financial agreements are linked to interbank rates. The conclusion is that the most recent financial unrest has so far had less of an impact on share prices and corporate rates than has been the case in previous episodes. The major effects of the unrest are particularly evident in the TED spreads.

Often slight effects on the real economy

The effects on the real economy arising from these periods of turbulence have varied. For instance, the effects of the unrest experienced in 1987, 1998 and 2001 were marginal (see Figure B4). One reason for this was that the central banks reacted by quickly cutting their policy rates.

During the years following the IT crash, however, there was a substantial slowdown in global GDP growth (see Figure B4).

In the United States, GDP growth fell from 3.7 per cent in 2000 to 0.8 per cent in 2001 and 1.6 per cent in 2002. There was some recovery in 2003. The slowdown in GDP growth was similar in Sweden and the euro area. However, there was later a clear recovery, both in Sweden and in the euro area.

The slowdown in global growth took place despite very strong economic policy stimulation. In 2001 the US central bank cut its policy rate from 6.5 per cent to 1.75 per cent. During the second half of 2003 and the first half of 2004 it was only 1 per cent. Monetary policy in the euro area and Sweden also took a more expansionary direction. However, this occurred slightly later than in the United States and the policy rates were slightly higher.

Fiscal policy also changed to a more expansionary direction. This applies in particular to the United States, where for instance income taxes were cut for households. During the years 2001-2003 fiscal policy in the United States was the most expansionary measured for at least 40 years. [4]

US housing market more crucial than financial unrest

The financial turbulence has so far thus not had such extensive repercussions on the financial markets as in earlier periods. This could indicate that its effects on developments in the real economy will not be too great. However, there is considerable uncertainty, both with regard to how the financial markets will develop following this and how great an influence this will ultimately have on the real economy.

What appears to be the greatest threat to economic developments is not the financial turbulence in itself, but rather the deteriorating situation in the US housing and mortgage market. [5] In this way the current situation is similar to that prevailing at the time of the IT crash, when both periods were characterised by unrealistic expectations and speculative elements that were followed by a substantial correction.

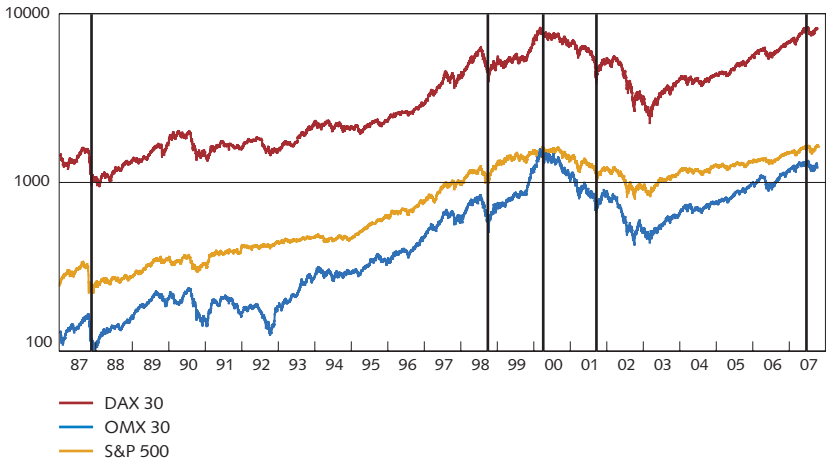
GDP growth in the United States is expected to be subdued in the near future due to a continued decline in investment in housing. This follows on from a fall in demand and the fact that the number of unsold houses has increased to a high level. Another factor that is expected to subdue economic developments is that a large share of the households with subprime loans will be forced to renew their loans at much higher interest rates over the coming quarters. The number of households with payment problems is therefore expected to continue to rise. This could lead to continued downward pressure on house prices and residential construction. Lower house prices lead to a reduction in household wealth and thus subdue household consumption. In addition, households' opportunities to finance their consumption by taking out additional/extended mortgages declines.

One cannot rule out the possibility that the decline in the US house market will have greater negative effects on employment and household consumption demand than was foreseen in the main scenario. This could in turn have negative effects on the world economy as a whole (see Chapter 2 for an analysis of this).

4 This can be analysed, for example, with the aid of the change in the structural, that is, the cyclically-adjusted, financial net lending.

5 To this can be added the risk that desire to own one's own home is also falling in other countries where house prices have in many cases recently risen faster than in the United States. This is a risk factor that is included in the analysis of the world economy made in the IMF World Economic Outlook, October 2007.

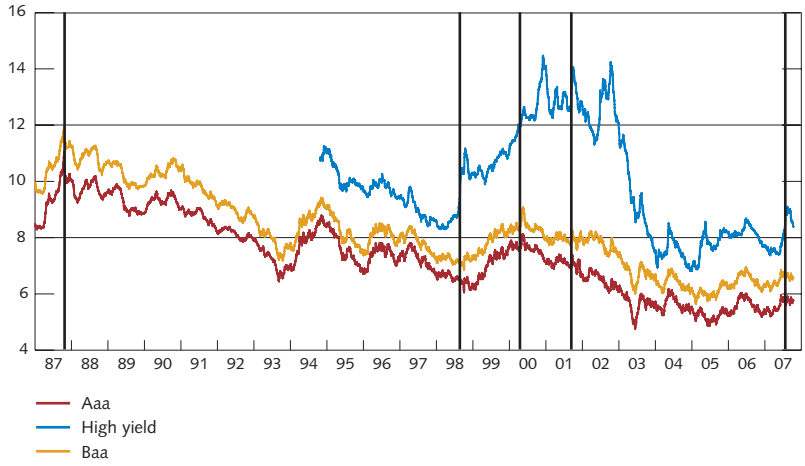
Figure B1. Stock market movements in the United States, the euro area and Sweden 1987-2007
Logarithmic scale, level



Note. The vertical lines indicate the beginning of different periods of turbulence.

Sources: Bloomberg and Reuters Ecowin

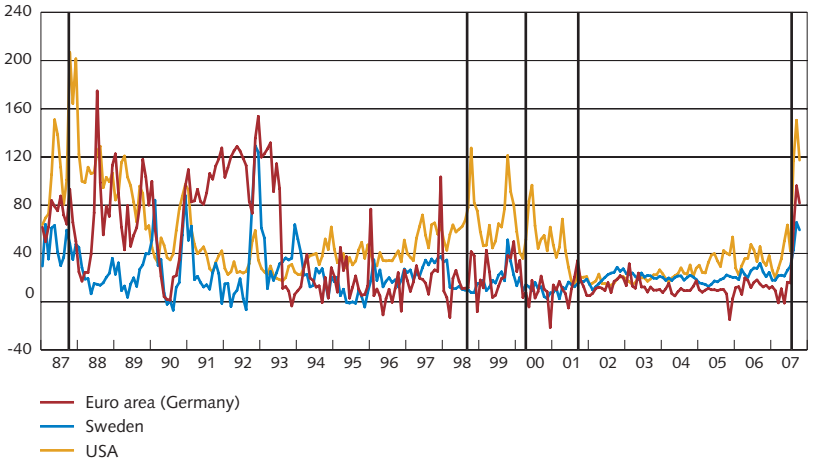
Figure B2. The corporate bond rate in the United States
Per cent



Note. The vertical lines indicate the beginning of different periods of turbulence.

Source: Reuters Ecowin

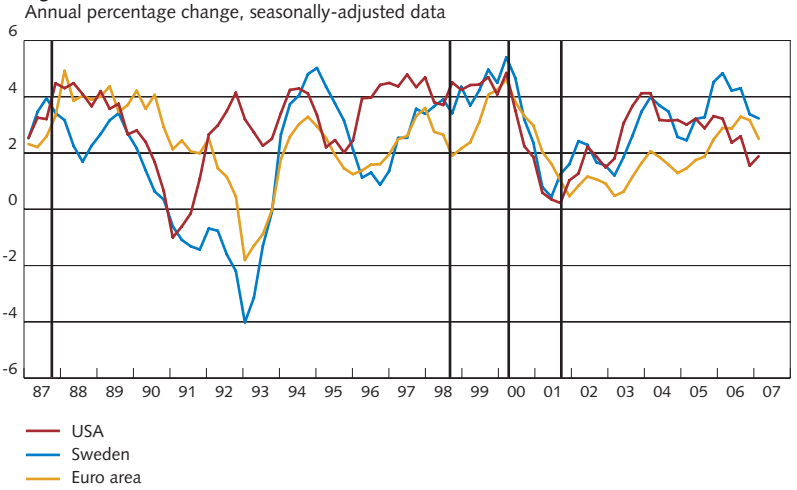
Figure B3. TED spreads in the United States, the euro area and Sweden
Basis points, monthly average



Note. The vertical lines indicate the beginning of different periods of turbulence.

Sources: Bloomberg and Reuters Ecowin

Figure B4. GDP in the euro area and Sweden
Annual percentage change, seasonally-adjusted data



Note. The vertical lines indicate the beginning of different periods of turbulence.

Sources: Bureau of Economic Analysis, ECB, Eurostat, Statistics Sweden and the Riksbank