Crisis, Recession and the Accelerator

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In a forthcoming annual economic symposium organized by the Bank of Thailand on September 15 and 16 one of the research papers focuses on the "Impacts of Financial Factors on Thailand's Business Cycle Fluctuations," highlighting how the "financial accelerator" amplifies and propagates economic shocks.

The problem in the financial market that began in 2007 has led to one of the most severe economic crises. A list of potential explanations includes excess global savings that pushed down real long-term interest rates around the world, subsequent credit booms caused by aggressive competition for borrowers by financial institutions, and rapid innovations in financial instruments that made credit risk easier to trade.

By now we are familiar with vogue expressions such as the global savings glut, credit bubbles and originate-to-distribute. Economists never fail to coin esoteric terms to explain what is going on in the real world. This article introduces yet another term: the "financial accelerator". This term has come into fashion, appearing in daily newspapers, the minutes of monetary-policy committees, and even testimony to the US Congress.

The idea of the financial accelerator reached its conceptual maturity in a seminal study by Ben Bernanke, Mark Gertler and Simon Gilchrist in 1999. The authors used it to explain the "adverse feedback" between financial strains and weakening economic activity. A decline in economic activity heightens financial strains - by aggravating the fall in asset prices, deteriorating borrowers' balance sheets and increasing the probability of defaults by households, firms, and financial institutions. These developments thereby induce higher borrowing interest rates and in turn cause a further contraction in real activity.

In short, the financial accelerator creates a self-reinforcing mechanism between activities in the financial market and the macro-economy. To break the negative feedback between 2

deteriorating financial conditions and weakening economies, central banks have reduced policy interest rates drastically, and governments have implemented extensive fiscal-stimulus plans.

In countries where the financial sector became the core of the financial crisis, policy-makers have engaged in purchasing toxic assets and injecting capital into financial institutions. The key goal is to restore the balance sheets of financial institutions and hence their ability to lend. In those countries where the financial sector remains relatively intact, the authorities have designed policy to limit damage to the real economy caused by a shortage of credit by introducing measures such as loan guarantees - a scheme by which the government assumes a private-debt obligation if the borrower defaults. Again, the key here is to encourage lending.

The current financial crises and recessions may be a perfect illustration of the financial accelerator at work today. Given a sudden short-lived disruption in financial markets, the accelerator and prolonged effect on the real economy.

(The views expressed are the author's own.)

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