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Costs of banking system instability: Some empirical evidence ☆

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Abstract

This paper assesses the cross country 'stylised facts' on empirical measures of the losses incurred during periods of banking crises. We first consider the direct resolution costs to the government and then the broader costs to the welfare of the economy – proxied by losses in GDP. We find that the cumulative output losses incurred during crisis periods are large, roughly 15–20%, on average, of annual GDP. In contrast to previous research, we also find that output losses incurred during crises in developed countries are as high, or higher, on average, than those in emerging-market economies. Moreover, output losses during crisis periods in developed countries also appear to be significantly larger – 10–15% – than in neighbouring countries that did not at the time experience severe banking problems. In emerging-market economies, by contrast, banking crises appear to be costly only when accompanied by a currency crisis. These results seem robust to allowing for macroeconomic conditions at the outset of crisis – in particular low and declining output growth – that have also contributed to future output losses during crises episodes. © 2002 Published by Elsevier Science B.V.

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☆ The views expressed are those of the authors and do not necessarily reflect those of the Bank of England. Glenn Hoggarth and Victoria Saporta are in the Financial Industry and Regulation Division, Bank of England. Ricardo Reis, who is currently at the Economics Department of Harvard University, contributed to this paper whilst working at the Bank of England.

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1. Introduction

Over the past quarter of a century, unlike the preceding twenty five years, there have been many banking crises around the world. Caprio and Klingebiel (1996, 1999), for example, document 69 crises in developed and emerging-market countries since the late 1970s. In a recent historical study of 21 countries, Bordo et al. (2001) report only one banking crisis in the quarter of a century after 1945 but 19 since then.

Although there is now a substantial cross country empirical literature on the causes of banking crises, [1] there have been fewer studies measuring the potential costs of financial system instability. Yet it is a desire to avoid such costs that lies behind policies designed to prevent, or manage, crises. This paper considers the ways in which banking crises can impose costs on the broader economy and presents estimates of those costs. In particular, the paper focuses on cross-country estimates of the direct fiscal costs of crisis resolution and the broader welfare costs, approximated by output losses, associated with banking crises.

The paper is organised as follows: Section 2 considers the various potential costs of banking crises and provides a brief overview of the channels through which they are incurred. Section 3 discusses briefly the general issues involved in measuring the costs of crises. Section 4 assesses the existing evidence on the fiscal costs of crisis resolution, and Section 5 presents a number of estimates of output foregone during crisis periods. Section 6 assesses the extent to which output losses are attributable to banking crises per se rather than due to other causes. Section 7 concludes.

2. Costs of banking crises – an overview

A crisis in all or part of the banking sector may impose costs on the economy as a whole or parts within it. First, 'stakeholders' in the failed bank will be directly affected. These include shareholders, the value of whose equity holdings will decline or disappear; depositors who face the risk of losing all, or part, of their savings and the cost of portfolio reallocation; other creditors of the banks who may not get repaid; and borrowers, who may be dependent on banks for funding and could face difficulties in finding alternative sources. In addition, taxpayers may incur direct costs as a result of public sector crisis resolution – cross-country estimates of these are shown below.

Costs falling on particular sectors of the economy may just reflect a redistribution of wealth, but under certain conditions banking crises may also reduce income and wealth in the economy as a whole.

[1] For example, see the literature review on leading indicators of banking crises by Bell and Pain (2000) and the references within.

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