

## Banking Crises Around The World

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by [John Mauldin](#)

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Do government bailouts in times of banking crises work? Philippa Dunne & Doug Henwood of The Liscio Report highlight a major study of 42 fairly recent banking crises around the world. Result? Some types of government intervention works and some don't. One characteristic that is needed though is speed. Dithering, a la Japan, is a recipe for disaster. This is a brief summary of the report (to which they provide a link) and their conclusions as to the basic outlines of what the US should do. Given that Europe is already in the throws of its own bank crisis, and the rest of the world could experience problems, this should be useful reading. They also provide graphs of banking crises and comparisons with developed countries and the resulting market experience.

One major point? This is like the old Fram oil filter commercial line "Pay me now or pay me later." As this study points out, the tax payers and citizens of the US (and the world) are going to pay for this crisis in one way or another. Either a major recession (with high and persistent unemployment), reduced incomes and tax collections or a collective efforts to stabilize the banking system. The costs of inaction are much higher. It is not a matter of cost or no cost. We are going to have to pay in one form or another.

We cannot avoid the costs given where we are today. The time to avoid cost was years ago reigning in Freddie and Fannie and proper oversight of the mortgage industry. We (Congress) missed that opportunity. (Sadly, we are going to re-elect the very leadership to both parties largely responsible for the neglect. There is plenty of blame to go around. No amount of partisan finger pointing by Speaker Pelosi shifts that blame.) However, we can choose the form of the cost will be paid in. Personally, I prefer collective efforts to 10% or more unemployment and the risk of an extended recession and its costs. I know this is not pure free market theory, and sticks in the craw of many of my readers, but when many of my neighbors and friends will be unemployed and businesses are suffering theory will not make a very good meal. Congress must act now. This report is a good reminder of what has worked in the past.

My thanks to Philippa and Doug for allowing me to send this as a Special Outside the Box. You can see their work and blog at <http://www.theliscioreport.com>.

John Mauldin, Editor  
Outside the Box

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# Banking Crises Around The World

## The Liscio Report On the Economy

October 1, 2008

Having rejected Henry Paulson's rescue plan, it's not clear what Congress --or those in the broad population opposed to a "bailout"-- propose to do to keep the financial system from imploding. But a database of systemic banking crises recently assembled by IMF economists Luc Laevan and Fabian Valencia ([www.imf.org/external/pubs/cat/longres.cfm?sk=22345.0](http://www.imf.org/external/pubs/cat/longres.cfm?sk=22345.0)) provides a useful map of how crises play out and what does and doesn't work.

Laevan and Valencia identify 124 systemic banking crises between 1970 and 2007, and assemble detailed information on 42 of them, representing 37 countries. (Some countries, like Argentina, appear multiple times.)

In almost every case, governments took active measures to mitigate the crisis, so there is no real test of whether rescue schemes actually work; no politician seems willing to face the consequences of letting the chips fall where they may. But the work of Laevan and Valencia does offer some guidance as to what works best.

## Dithering Costs

One crucial lesson stands out: speed matters. This is obvious to anyone who followed Japan's dithering in the 1990s; standing aside and hoping the problem goes away is not a good idea. Relatedly, "forbearance" --regulatory indulgence, such as permitting insolvent banks to continue in business-- does not work, as has been established in earlier research. As the authors say, "The typical result of forbearance is a deeper hole in the net worth of banks, crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance." This suggests that suspending mark-to-market requirements is not a good idea.

Since forbearance does not work, some sort of systemic restructuring is a key component of almost every banking crisis, meaning forced closures, mergers, and nationalizations. Shareholders frequently lose money in systemic restructuring, often lots of it, and are even forced to inject fresh capital. The creation of asset management companies to handle distressed assets is a frequent feature of restructurings, but they do not appear to be terribly successful. More successful are recapitalizations using public money (which can often be partly or even fully recouped through privatization after the crisis passes); recaps seem to result in smaller hits to GDP. But they're not cheap: they average 6% of GDP, which for the U.S. would be about \$850 billion.

Total fiscal costs, net of eventual asset recoveries, average 13% of GDP (over \$1.8 trillion for the U.S.); the average recovery of public outlays is around 18% of the gross outlay.

But those who don't want to spend that kind of taxpayer money should consider this: Laevan and Valencia find that "[t]here appears to be a negative correlation between output losses and fiscal

costs, suggesting that the cost of a crisis is paid either through fiscal costs or larger output losses." And if the economy goes into the tank, government revenues take a big hit, so what's saved on the expenditure side could well be lost on the revenue side.

Oh, and about half the countries that have experienced crises have had some form of deposit insurance. So merely expanding the FDIC's coverage is not likely to do the trick --and, in any case, it's going to be hard to escape the huge expense of a systemic recapitalization, though using the FDIC might simplify the politics of the rescue.

(A note on the politics of the rescue: an ABC poll shows the public to be far more worried about the economic consequences of the bailout's defeat than Congress seems to be. There's not a lot of enthusiasm for what's seen as handing money over to Wall Street --but if properly structured and sold, say with more cost recovery prospects for the government, more relief for debtors, a rescue is not as unpopular as some would have it.)

## **Relevant Examples**

Most of the countries in the Laevan/Valencia database are in the developing world, and are of questionable relevance to the U.S. But TLR has taken a closer look at four countries that offer more relevant models: Japan, Korea, Norway, and Sweden. Some major stats for the four and the U.S. are in the table at the end of the newsletter, and graphs of some important indicators are there as well.

Sweden, now widely seen as a model of swift, bold action, kept its ultimate fiscal costs relatively low --3.6% of GDP at first, almost all of which was recovered through stock and asset sales-- but was unable to avoid a deep recession. At the other end of the spectrum, Japan, the model of foot-dragging half-measures, saved no money through its procrastination; its fiscal outlay was 24% of GDP, almost none of which was recovered. And it was unable to avoid recession.

Note, though, that some of the worried talk surrounding the financial market impact of bank bailouts looks misplaced, at least on these models. Three years after the outbreak of crisis, inflation was lower and stock prices higher in all four countries, and government bond yields were lower in all but Japan. It's likely that the deflationary effects of a credit crunch outweigh the inflationary effects of debt finance.

Although the U.S. in 2007 had a lot in common with other countries on the brink of a banking crisis, one thing stands out: the depth of the current account deficit. Of the four comparison countries, only Korea comes close to the U.S. level of red ink. The unweighted average current account deficit of the 42 countries in the Laevan/Valencia database was 3.9% of GDP -- compared with 6.2% for the U.S. That suggests that the U.S. has more to deal with than just resolving a banking crisis.

## **A Better Bailout**

So, with the modified Paulson plan dead for now, what might a better bailout scheme look like in light of the Laevan/Valencia historical database?

First, it must be adopted quickly. Perhaps operating through the FDIC would be a way to accomplish that, though the FDIC will almost certainly need to have its coffers copiously refilled.

Second, forbearance would be a bad idea; it does no one any good not to face reality.

Third, purchasing bad assets and turning them over to an asset management corporation is not a promising strategy.

Fourth, recapitalizing the banks should be the heart of any policy; as the authors say, it should be selective, meaning supporting those institutions with hope of revival, and letting the terminal go down.

And fifth, targeted relief for distressed debtors, supported with public funds, has also shown success in earlier banking crises, and should be part of any rescue scheme in the U.S. as well.

Crises like this are manageable. They're expensive and painful to resolve, but even more expensive and painful when left to fester.

**-- Philippa Dunne & Doug Henwood**

**Bailout Stats And Graphs**

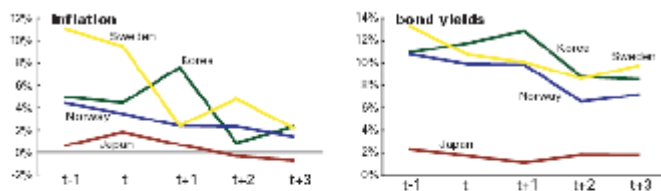
### banking crises: some stats

	Japan	Korea	Norway	Sweden	U.S.
start	1997	1997	1991	1991	2007
<b>fiscal cost</b>					
gross	21.0%	31.2%	2.7%	3.6%	
net	23.9%	21.7%	0.8%	0.2%	
output loss	17.6%	60.1%	0.0%	0.0%	
minimum growth	-2.0%	-8.9%	2.8%	0.7%	
<b>pre-crisis</b>					
fiscal balance	6.1%	0.2%	2.6%	3.4%	2.6%
public debt	100.5%	8.8%	28.9%		60.1%
inflation	0.6%	4.0%	4.4%	10.9%	2.6%
GDP growth	2.8%	7.0%	1.9%	1.0%	2.8%
current account	1.4%	-4.1%	2.5%	-2.6%	-8.2%
<b>recap costs</b>					
gross	6.6%	19.3%	2.6%	1.9%	
net	6.9%	19.8%	0.6%	1.6%	
<b>three years later</b>					
CPI	-2.5%	-2.1%	-2.0%	-7.3%	
gov bonds	0.1%	-3.2%	-4.7%	-1.0%	
stocks	10.9%	12.1%	23.0%	41.0%	
employment	-1.7%	0.2%	1.3%	-10.6%	

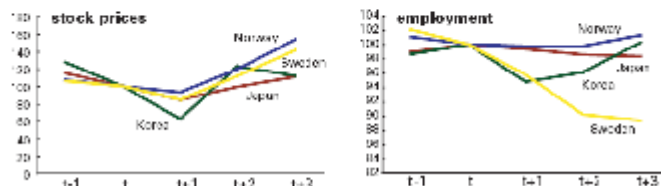
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All percentage figures except inflation, GDP growth, bond yields, stock prices, and employment are percent of GDP. Gross fiscal cost is total outlays for banking system support; net is after equity and asset sales. Output loss is total deviation from trend growth rate in GDP from the crisis year through three years after crisis onset, expressed as a percent of trend GDP. Minimum growth is the lowest level of GDP growth reached during the crisis. Pre-crisis stats are for the year before the onset of the crisis. Recap costs are costs of cash, equity, or debt injections or asset purchases to recapitalize the banking system; net is after recovery of these costs through asset sales and the like. Stats labeled "three years later" are changes in indicators three years after crisis onset. "Gov bonds" are bond yields reported by the IMI in its *International Financial Statistics* database. "Stocks" are based on the stock indexes published in *I-F-S*. Stats in the first eleven rows come from "Systemic Banking Crises: A New Database," by Paul Seaman and Fabian Valencia (IMF Working Paper 08/224) and the associated spreadsheets available from [www.imf.org/external/pubs/cd/longres/inf?sk=2234b.0a](http://www.imf.org/external/pubs/cd/longres/inf?sk=2234b.0a). The next four rows are computed by TLR from the *I-F-S* database.

### bailout effects



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Consumer price inflation, government bond yields, stock prices, and employment, from one year before a banking crisis (t-1) to three years after (t+3). Stock prices and employment are indexed so that the year of crisis onset, t, is set to 100. Annual data. Source: IMF.