Managing Financial Crises

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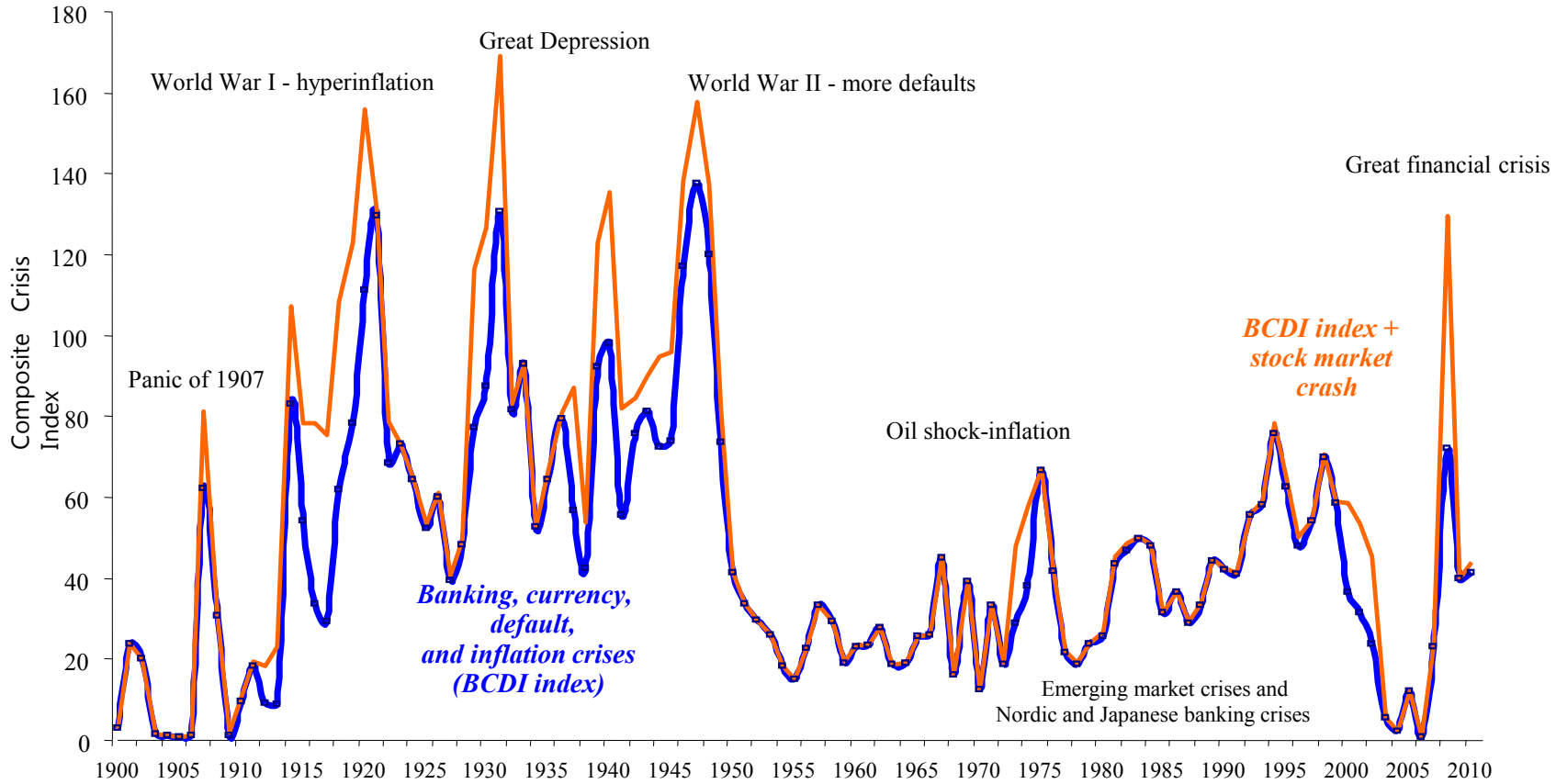
There have been many crises, everywhere and of various types

- There have been many crises over centuries
  - More common in emerging markets earlier, but great financial crisis (GFC) affected predominantly advanced countries
  - Crises come in (regional) waves: Latin America, Asia, US/Europe…
- While causes vary by type, they are interrelated
  - Boom (and bust) patterns are common to most
  - Banking, currency and sovereign crises can overlap since one can lead to the other
- But identifying and classifying crises is still an art
  - Samples vary, and so do related studied consequences…

Crises are recurrent events. So one can learn from history…

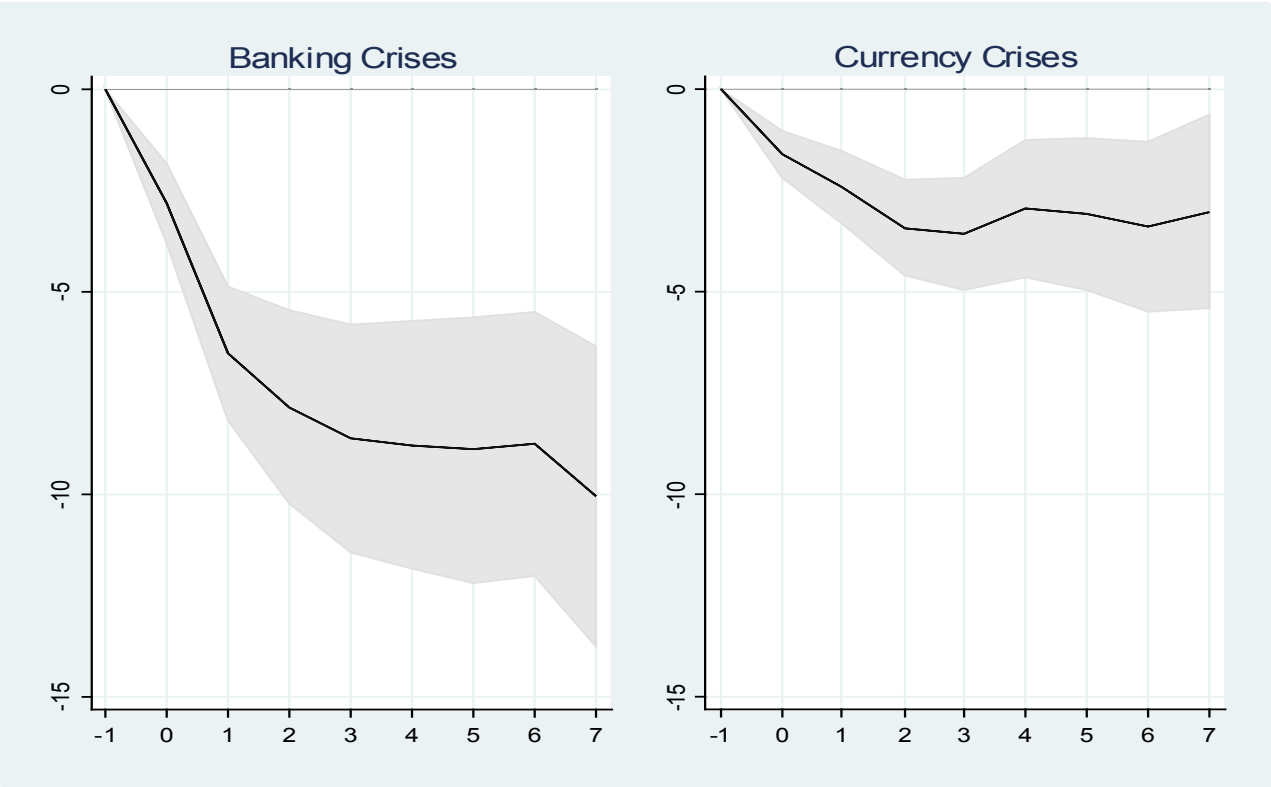
World aggregate (1900–2010): A composite index of banking, currency, sovereign default and, inflation crises, and stock market crashes (weighted by their share of world income)



Source: Reinhart and Rogoff, 2010

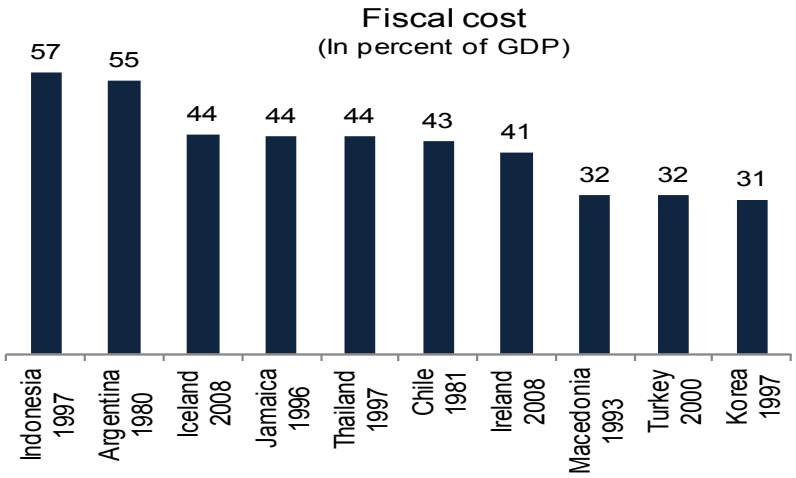
Financial crises can have large and long-lasting effects on the real economy

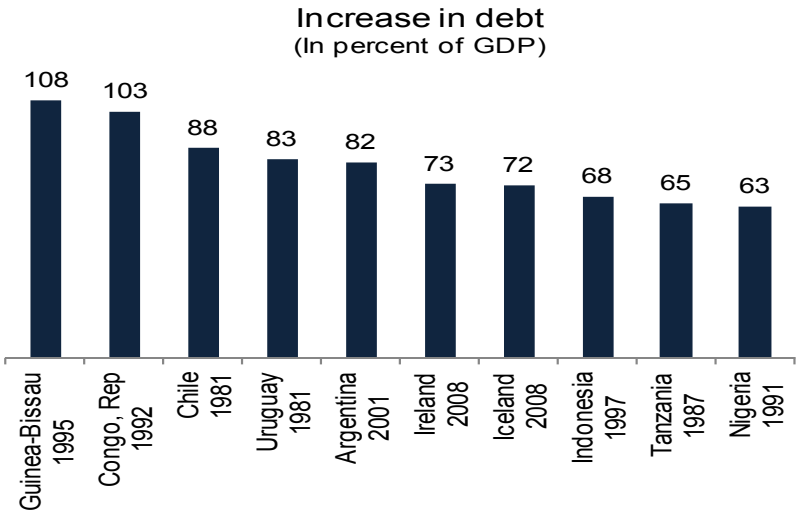
Output Evolution after Banking and Currency Crises (Percent of pre-crisis trend)

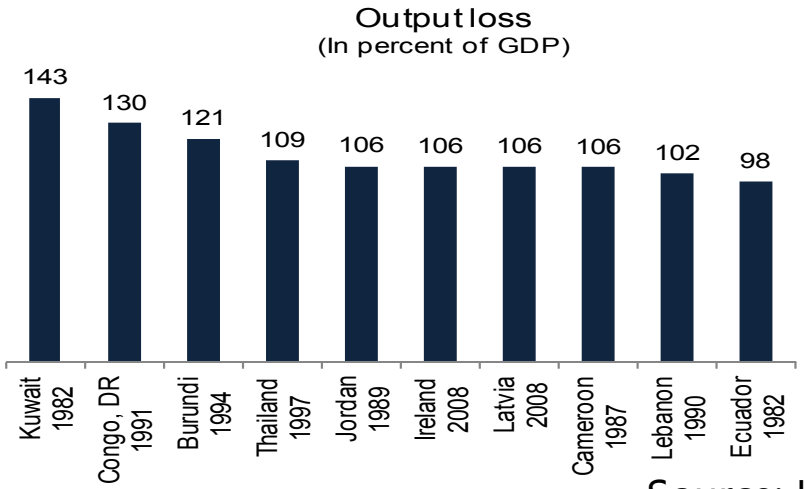


Note: Figure reports mean difference from year t = –1; 90-percent confidence interval for estimated mean; first year of crisis at t = 0; years on x-axis.

Costliest banking crises since 1970s includes some recent crises







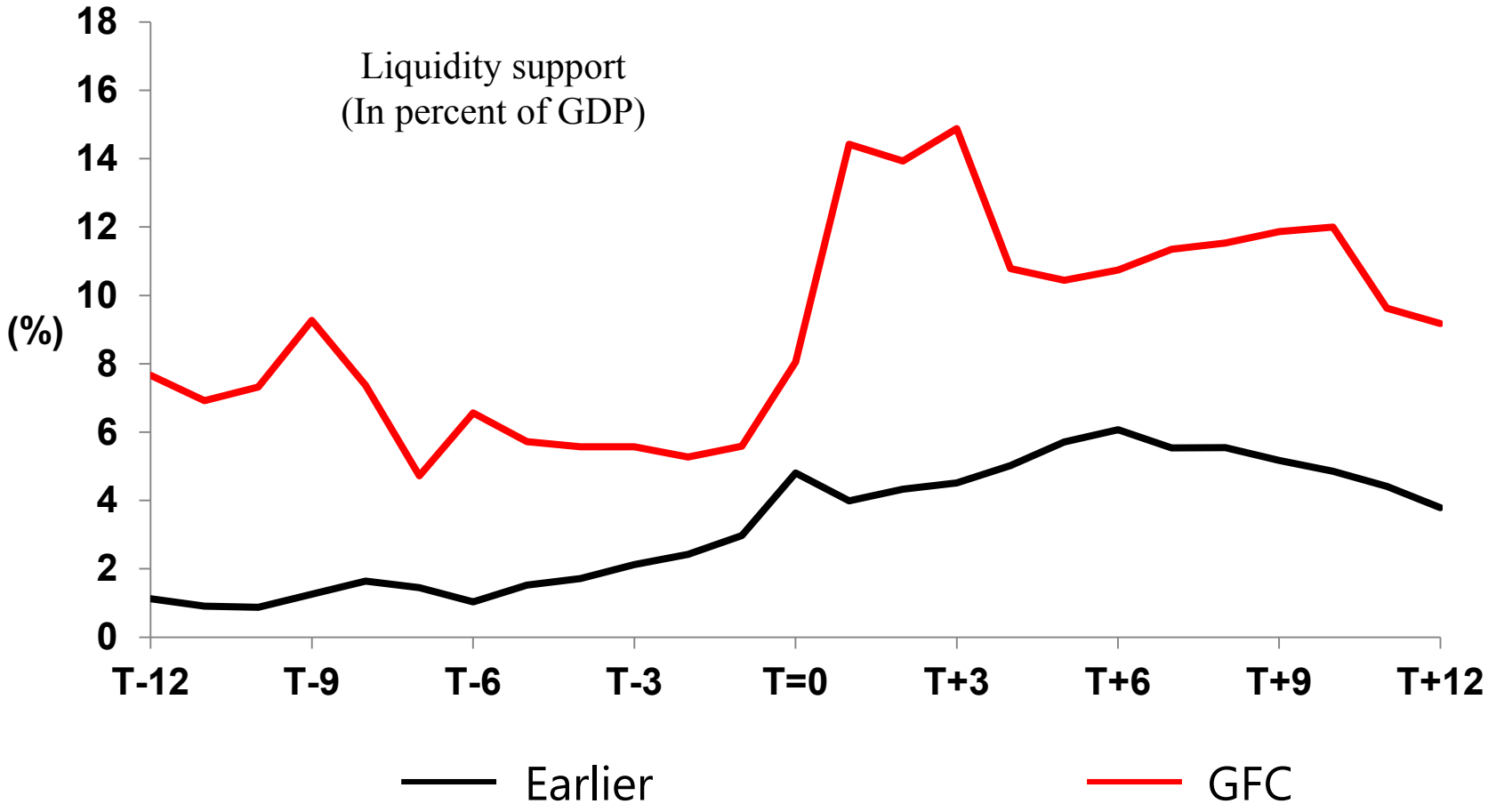
Source: Laeven and Valencia (2012)

Comparing causes provides lessons… As does comparing crises management

- Approaches vary
  - What differs every time?
  - Does it matter?
  - What to do for the next crisis?

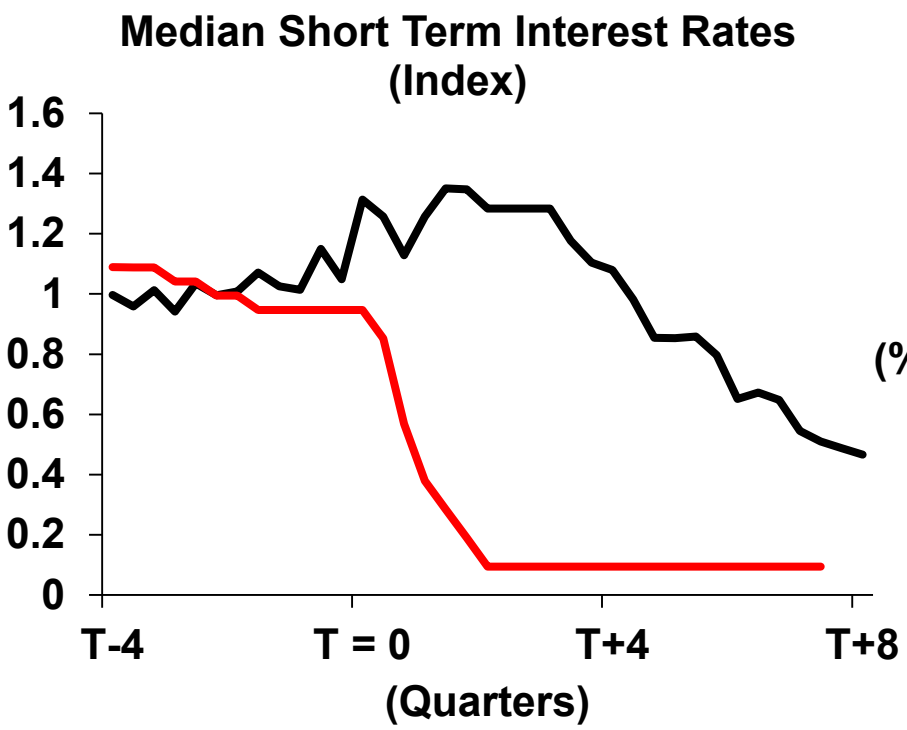
- Compare banking crises for samples of countries
  - GFC: 12 countries, of which 10 are advanced
  - Earlier crises: 18 countries, of which four are advanced
- How do policy choices and outcomes differ?
  - All unique, but some commonality in causes
  - GFC was more global

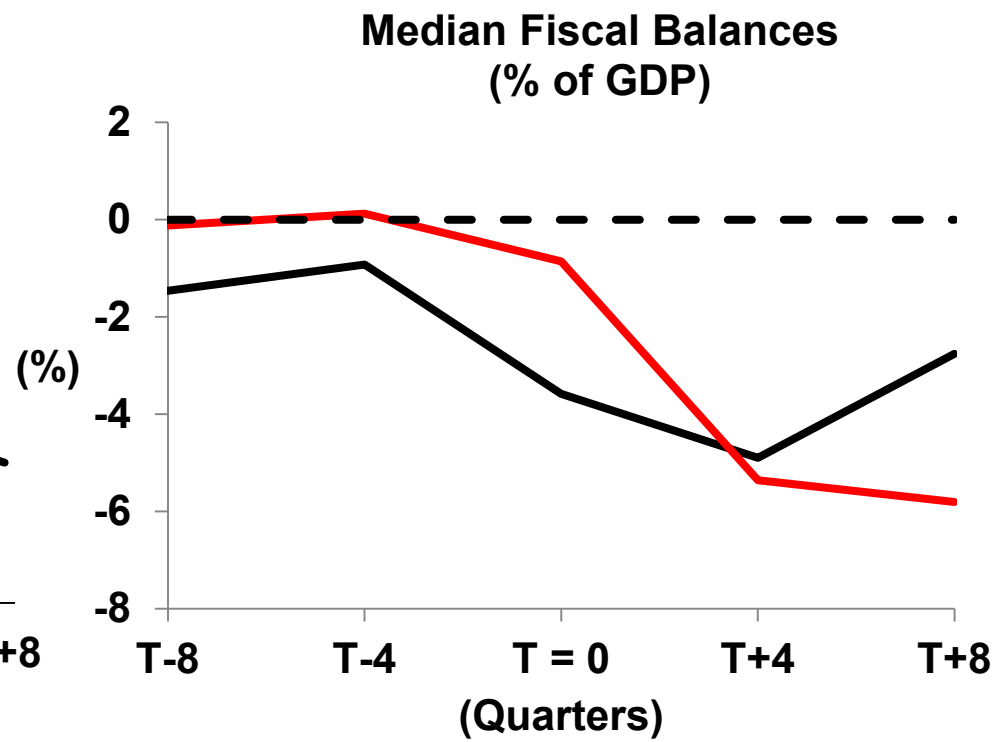
Liquidity support much larger in GFC



Note: All dates are relative to the peak of the crisis, with periods referring to **quarters** before or after onset of crisis. Medians.

Monetary and fiscal policy provided more support in GFC than in the earlier crises…





Earlier

GFC

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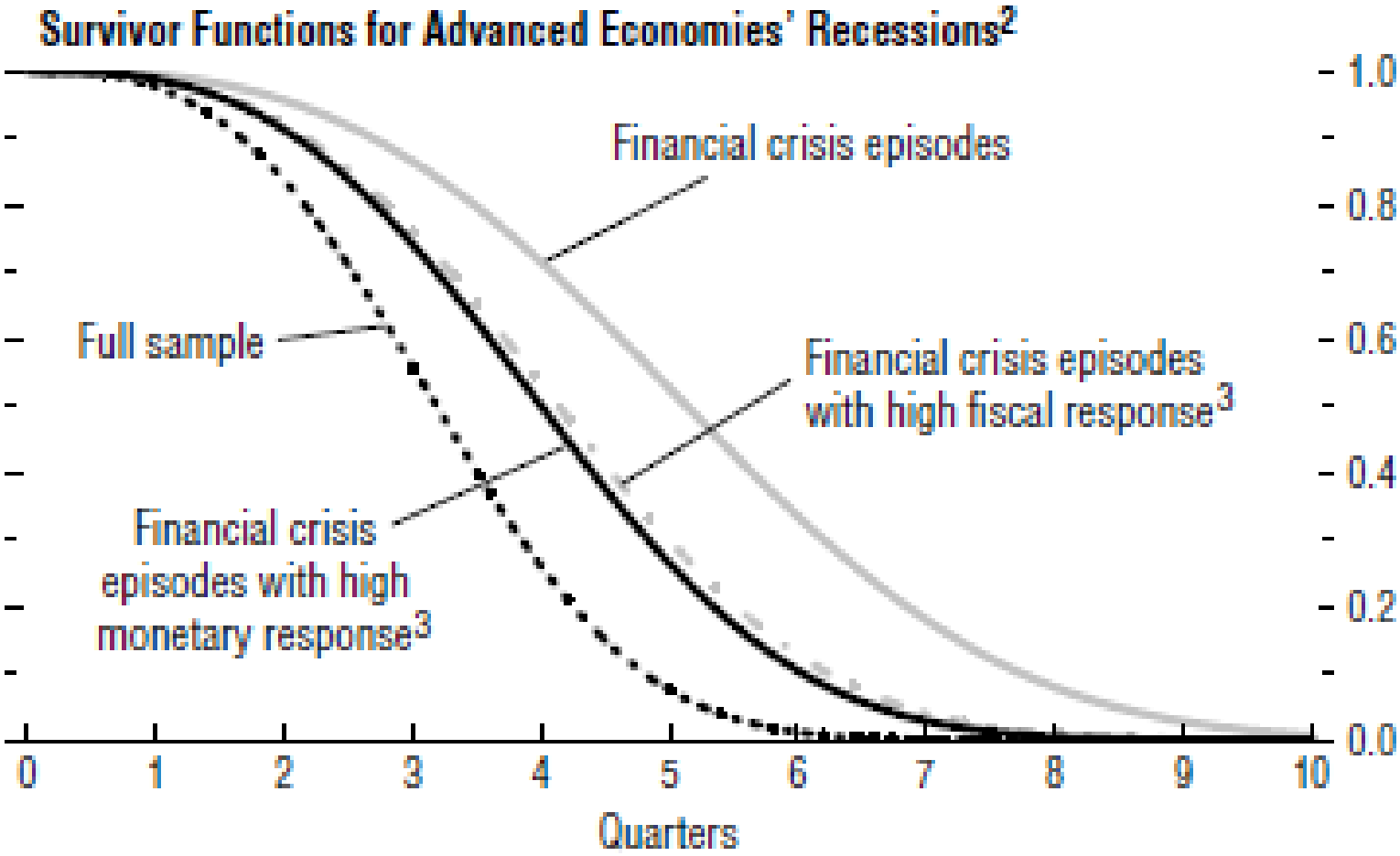
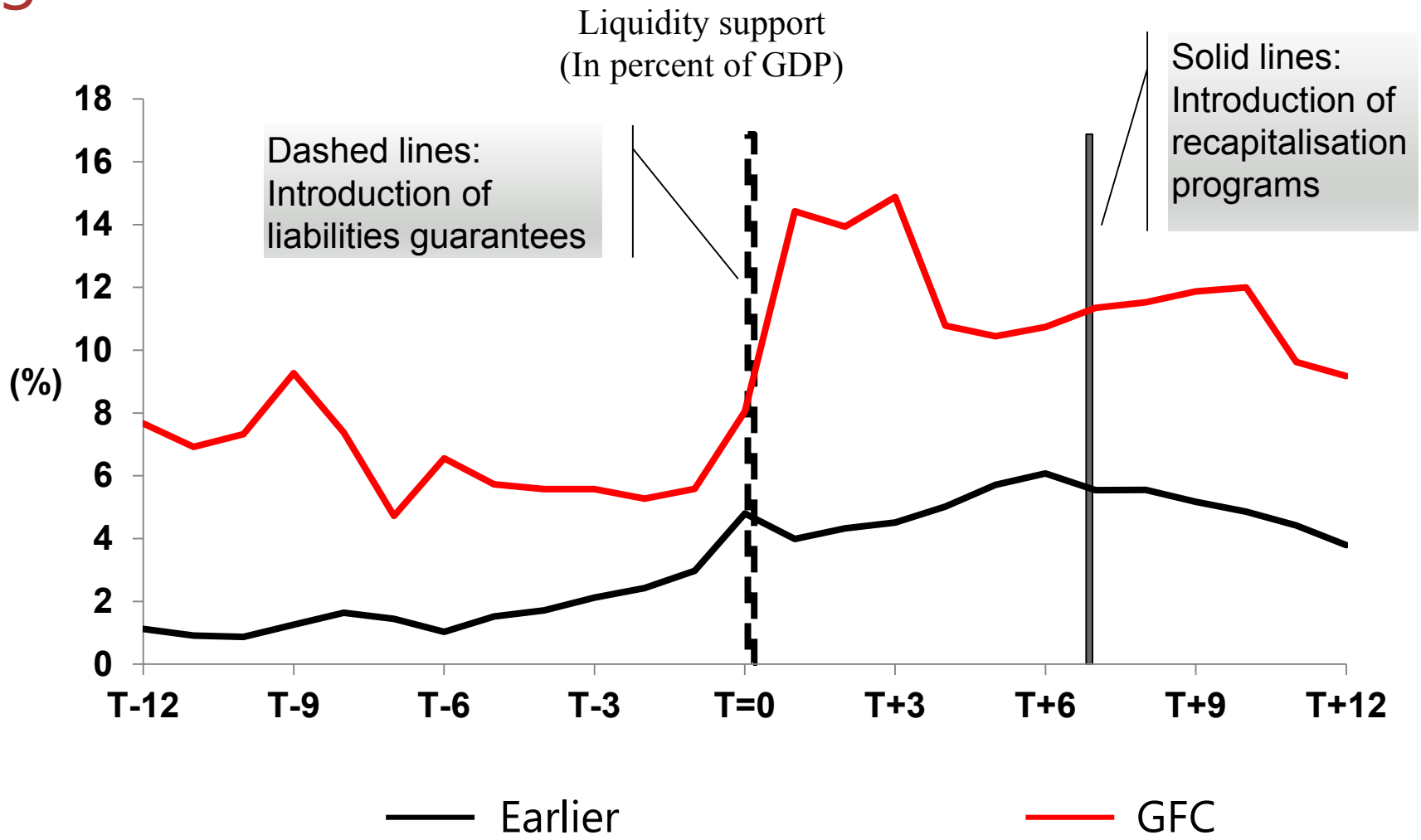
The real effects of crises were thus mitigated



Probability of remaining in a recession in a sample of recessions with and without financial crises.

Public recapitalisation was seven quarters after guarantees extended in earlier crises



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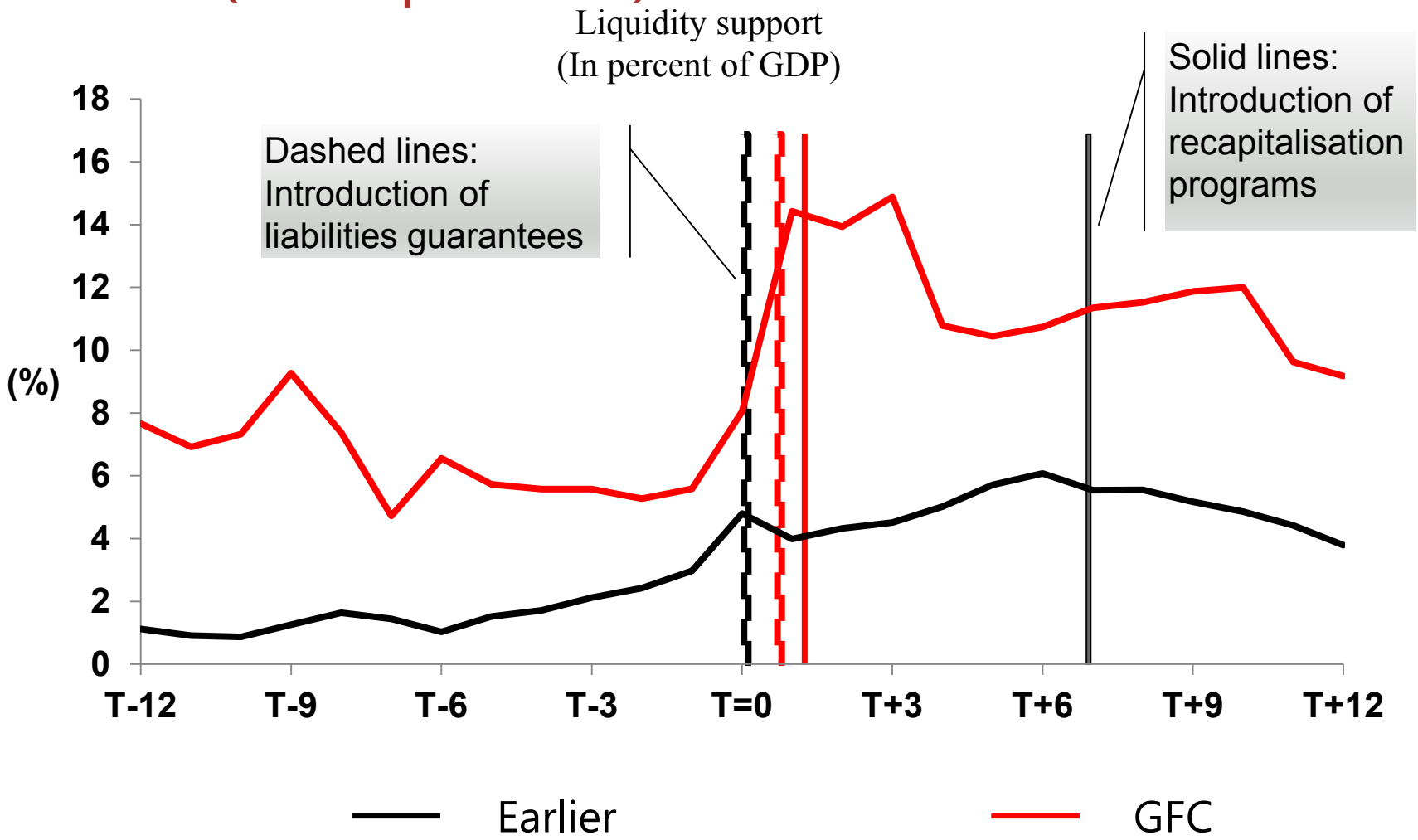
But in GFC, public recapitalisation much sooner (two quarters)



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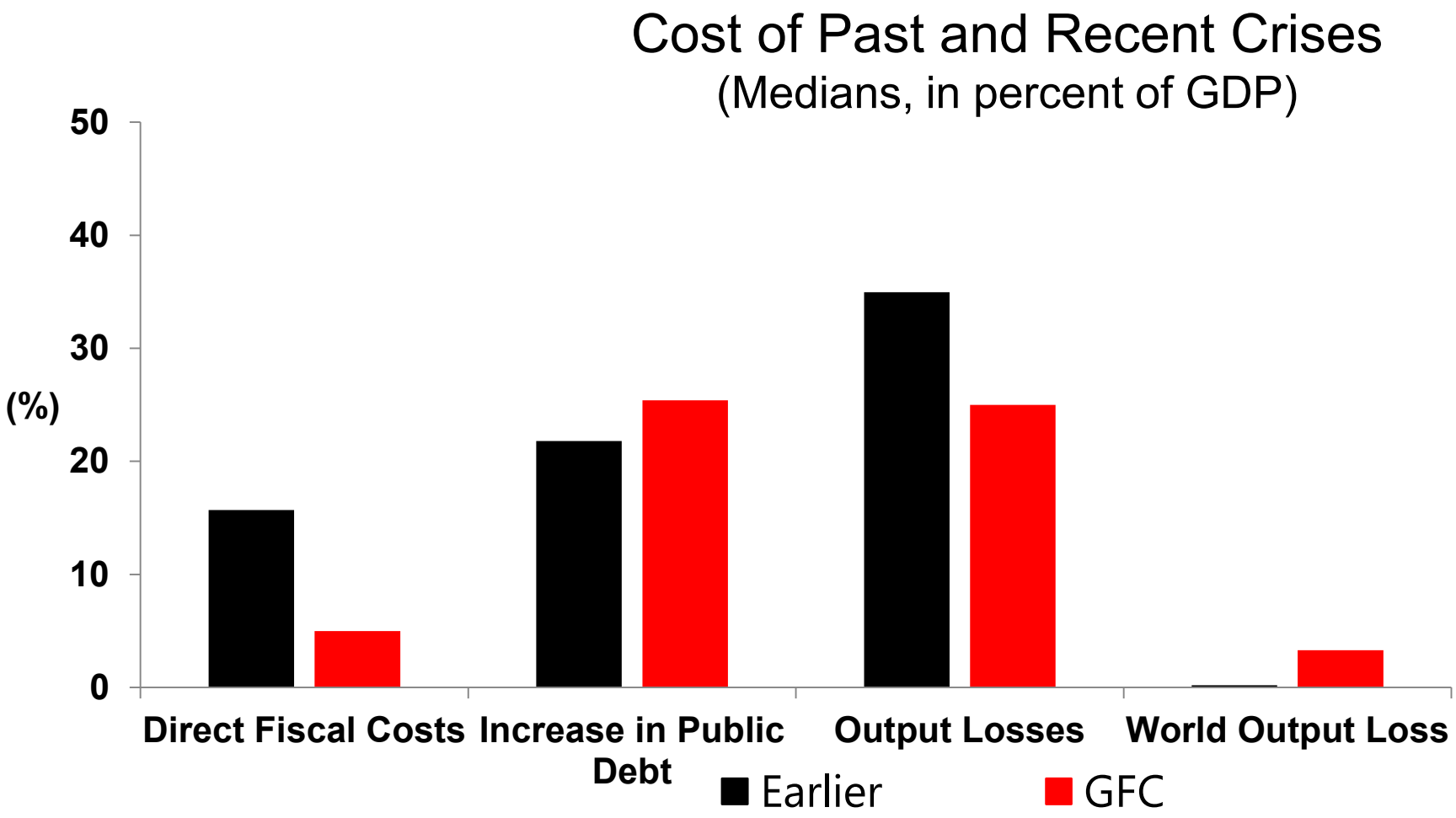
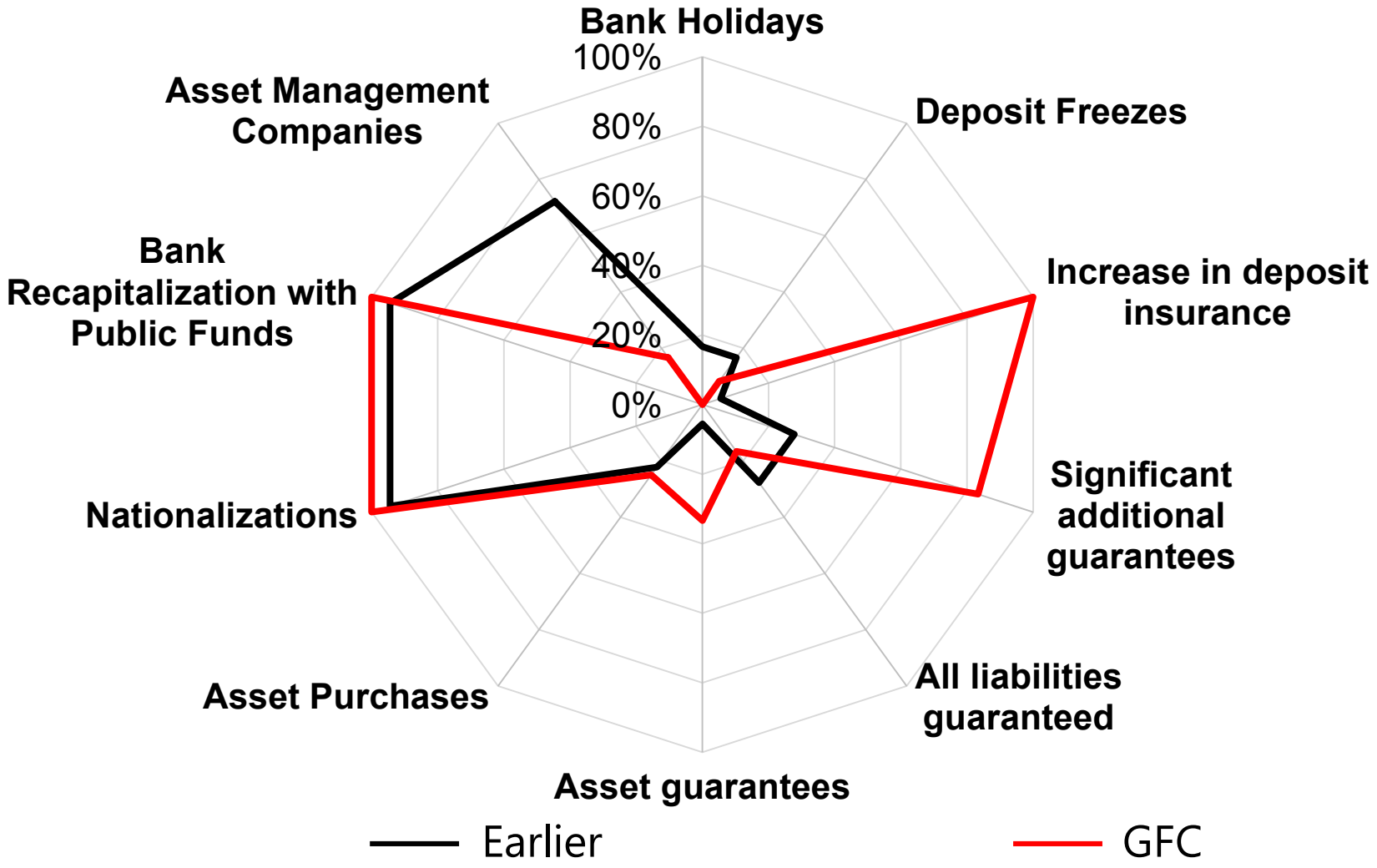
And while private markets contributed more, thus lower initial fiscal costs, in GFCs public debt (countercyclical fiscal) and global costs (more severe crisis) were higher



Restructuring in GFC vs past were qualitatively similar, except for guarantees, DI and AMCs



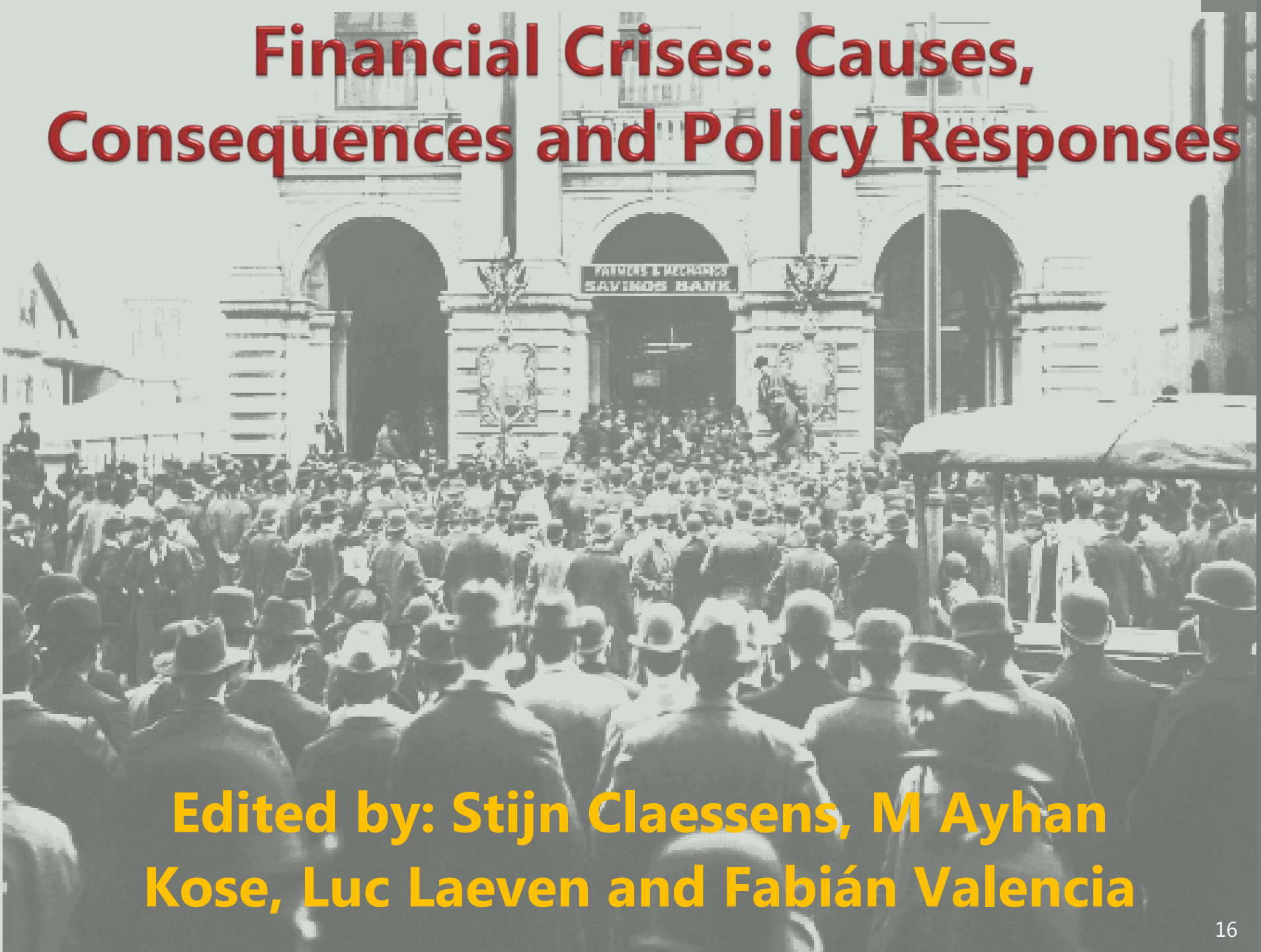
Resolution is key. Less differentiation, less 'conditionality' ⇒ less deep restructuring

- Viability assessments limited ex-ante (too little time)
  - Stress tests ex-post, and of varying quality
- Conditions for assistance limited
  - More/easier support to potentially non-viable institutions ("open bank assistance"), little resolution feasible
- 'Traditional' restructuring tools much less used
  - Limited asset restructuring, eg mortgages
  - More reliant on flow measures and monetary policy

Lessons for deposit insurance in crises

- Deposit insurance serves multiple goals for a single bank
  - Prevent runs
  - Protect depositors
  - Ease resolution
- Deposit insurance important too in systemic crises
  - Prevent system-wide runs
  - Help protect depositors as well as other creditors
    - Eg leverage guarantees provision
  - Ease resolution overall
    - Build on experience
- Lessons on deposit insurance in systemic crises
  - More still to be learned, especially on resolution

Financial Crises: Causes, Consequences and Policy Responses



Edited by: Stijn Claessens, M Ayhan Kose, Luc Laeven and Fabián Valencia