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# Costs of banking system instability: some empirical evidence

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Glenn Hoggarth, Ricardo Reis and Victoria Saporta

Over the past quarter of a century, unlike the preceding 25 years, there have been many banking crises around the world. Although there is now a substantial empirical literature on the causes of such crises, there have been fewer studies measuring their potential costs. Yet it is a desire to avoid such costs that lies behind policies designed to prevent, or manage, crises.

This study considers the ways in which banking crises can impose costs on the broader economy and presents cross-country estimates of the direct resolution costs and the broader welfare costs, approximated by output losses, associated with banking crises.

In a sample of 24 banking crises estimated resolution costs are found to be bigger in lower-income countries and those with higher degrees of banking intermediation. Countries with large fiscal costs of crises have in the past often experienced a simultaneous currency crisis, especially those that had in place a fixed exchange rate regime.

However, resolution costs may simply reflect a transfer of income from taxpayers to bank 'stakeholders' rather than necessarily the cost to the economy as a whole. An alternative, albeit still imperfect, proxy for the latter is the impact of crises on output.

Cumulative output losses (relative to trend) incurred in a sample of 47 banking crises are also investigated in this

study. Output losses are found, on average, to be large—around 15%–20% of annual GDP. Losses are usually much larger in the event of a twin banking/currency crisis than if there is a banking crisis alone, particularly in emerging market countries. Crises have also typically lasted longer in *developed* countries than in emerging markets. Because of this, on some measures, output losses during crises are larger in developed than in emerging market countries.

However, a crucial issue in measuring output losses is deciding whether they are caused by the banking crises, and are thus *costs* of banking crises, or whether recession caused the crises. In an attempt to answer this question output losses in a sample of 29 *systemic* banking crises are compared with neighbouring countries that did not at the time face severe banking problems. Banking crises but not currency crises were found to significantly affect output in developed countries, while the opposite was true in emerging market countries. These results also seem to hold up after allowing for other factors that may have caused output to fall.

It seems to be the case that regardless of whether banking crises cause or are produced by recession, they exacerbate subsequent output losses and are often costly to resolve.