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Discussion

Comment on "Costs of banking system instability: Some empirical evidence"

Patrick Honohan

World Bank, 1818 H Street N.W., Washington, DC 20433, USA

We have become accustomed to thinking that it is poor countries that suffer most from banking crises. This view is challenged by Glenn Hoggarth, Ricardo Reis and Victoria Saporta (HRS), who focus on the output loss caused by banking crises.

There are several new things in this paper. First, new estimates of output losses during 42 banking crises around the world. Second, analysis of these estimates suggesting *inter alia* that rich countries may actually do worse out of banking crises on average than poor countries, at least when "doing worse" is measured by the new measure of output losses. Obviously this begs the tough question how much of output fluctuations are explainable by banking crises, and (thirdly) the authors present a brave attempt to quantify this too.

Let me take these three points one by one. Pointing out the weaknesses of one standard approach to measuring output losses (the so-called IMF 1998 approach, which sums the annual gap between actual and trend GDP growth rates for the period until the growth rate returns to its previous average), the authors argue that it is desirable not to take "bygones as bygones" but to cumulate the total shortfall of the level of output below the previous trend path of output itself, not just of its rate of growth.

The new measure (GAP2) is only weakly correlated with the old (the correlation coefficient being just 0.33), and insignificantly so with fiscal costs, so we are definitely dealing with a new animal here (see Fig. 1). Still, we need to treat it with caution when we see some of the numbers the method turns up.

For developing countries the measured range is very wide indeed: from −47% in Ghana (output growth accelerated there while they were addressing the banking problems) to +112% of GDP during the 1980s in the Philippines. It is instructive

E-mail address: phonohan@worldbank.org (P. Honohan).

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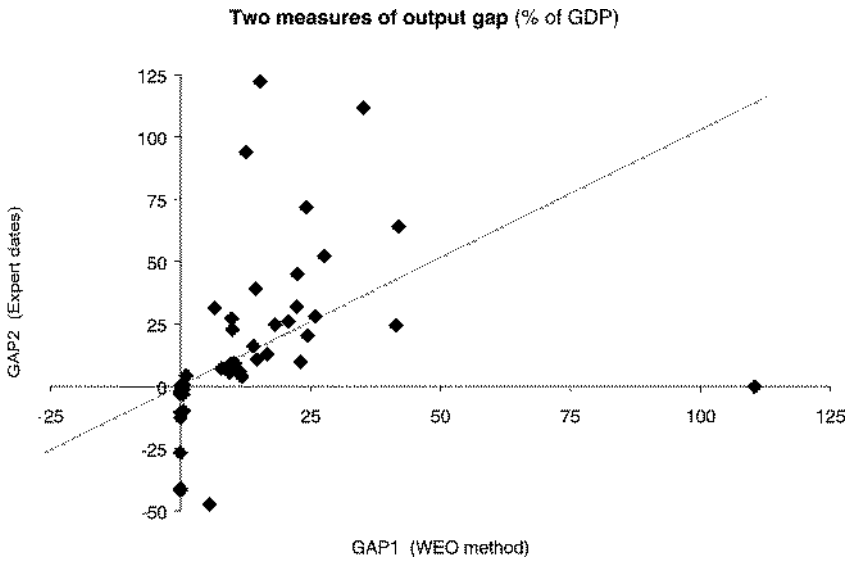

Fig. 1. Comparing the two measures of output cost (*source:* Hoggarth et al.).

to recall the circumstances of the crises that are here associated with such extreme measures of cost.

- Ghana's government-owned banking system was deeply insolvent long before officially recognized as such following the change of government in the early 1980s. The duration of Ghana's banking crisis as recorded in all the sources (from recognized onset to resolution) coincides with the adoption of sweeping economic reforms that made Ghana one of the top economic performers in Africa during the 1980s. Hence the apparent negative cost of the crisis recorded in measure GAP2. But of course this cannot be the reality.
- On the other hand, the corrupt Marcos regime still hung on after it had looted the main Philippine banks, and the political crisis helped pitch the economy into a downturn during the period recorded as one of banking crisis. Here again identification of the cost of banking crisis with the economic downturn is problematic.

These oddities – as well as the very high 72% of GDP cost obtained for Japan – make me reluctant to abandon the traditional view that developing economies have suffered more severely from banking crises.

As the authors indirectly acknowledge, the output dip is not necessarily a better measure of total economic costs than the fiscal cost. For me, the output dip is related to only one of three distinct cost elements that are (more or less) additive.

1. The *stock component* is the accumulated waste of economic resources that is *revealed* by the insolvency.

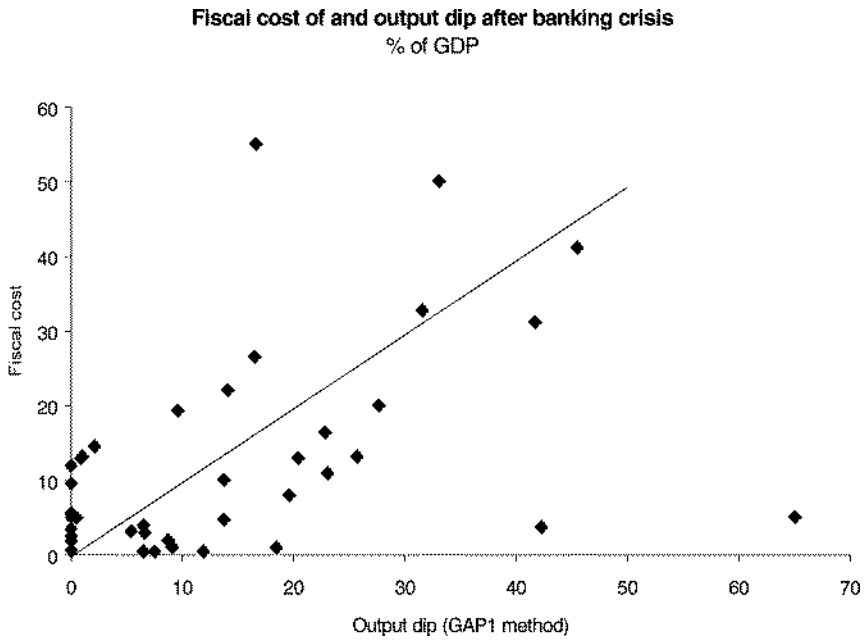

Fig. 2. Estimates of fiscal costs and of the output dip (GAP1 method) for 39 banking crises (*source:* Honohan and Klingebiel, 2000).

2. The *public finance component* of the true economic costs, which importantly is not the same as the fiscal bill. From an economic cost calculation, this cash "fiscal cost" is merely a transfer to depositors, but it does also entail a deadweight economic cost which can represent a sizable fraction of the amount transferred where the marginal cost of social funds is high.
3. The *flow component* of the economic cost arises from the subsequent output slumps caused by the banking crisis. (This is clearly an economic cost inasmuch as resources are underemployed until the economy picks up again).

The output dip reflects just one part of the problem and not necessarily the largest part. Indeed, the other two parts may be more closely correlated with fiscal cost. (The larger the initial capital deficiency of the failed banks, the larger the cash fiscal cost and the larger each of the components of the true economic cost is likely to be). Intriguingly, fiscal cost and the GAP1 output measure are not only correlated (Fig. 2), but of approximately the same size. [1]

My conjecture (may be it's a prejudice): fiscal costs are a better proxy for measuring total economic costs than any of the output dips.

[1] If three outliers are discarded, the correlation is 0.7 and a regression line implies an approximate one-to-one relationship between flow output costs and fiscal costs. If outliers are not discarded, the correlation is still 0.58.

(Of course there is an additional question that could be asked, namely whether by increasing one component of the costs, the government can achieve a reduction in other components. One's ability to tackle such a question pre-supposes, however, that we have got a good quantitative grip on each of the different components.)

A most interesting part of the paper is trying to assess to what extent the output losses can be attributed to the banking crisis *per se*. This the authors do by selecting a neighboring non-crisis country for each crisis country and measuring the difference between the GAP measure for each. The answer (for developing countries) is that 10 of the 16 percentage point GAP remains unexplained (even though the neighbor might have been contaminated by the crisis). This is a useful albeit simple exercise, though I don't think it fully disposes off the problem. After all, output dips are serially correlated, long-lived things, especially in developing countries. A dip caused by some other factor (return to normal after credit or fiscal excesses, commodity price decline, economic transition, etc.) could easily have triggered the onset of the banking crisis early on, [2] and still generate a sizable GAP in the subsequent years. It is no coincidence that the GAP measure is less when the pre-crisis period used to project the counterfactual output trend is one year rather than three.

[2] And remember that banking crisis onset is remarkably difficult to forecast, implying that it is a leading indicator of the cycle: my point is that this does not ensure that it is casual.