Systemic Financial Crises

Faced with a systemic financial sector crisis, policy makers need to make difficult choices under pressure. Based on the experience of many countries in recent years, few have been able to achieve a speedy, lasting, and low-cost resolution. This volume considers the strengths and weaknesses of the various policy options, covering both microeconomic (including recapitalization of banks, bank closures, subsidies for distressed borrowers, capital adequacy rules, and corporate governance and bankruptcy law requirements) and macroeconomic (including monetary and fiscal policy) dimensions. The contributors explore the important but little understood trade-offs that are involved, such as among policies that take effect quickly, those that minimize long-term fiscal and economic costs, and those that create favorable incentives for future stability. Successfully implementing crisis management and crisis resolution policy required attention to detail and a good flow of information. The differing underlying institutional requirements for the success of policy tools such as depositor guarantees, government-sponsored asset management companies, and the liberalization of foreign bank entry are discussed.

Patrick Honohan is Senior Financial Policy Advisor at the World Bank. Previously he was Economic Advisor to the Taoiseach (Irish Prime Minister) and spent several years as Professor at the Economic and Social Research Institute, Dublin, and at the Central Bank of Ireland. Dr. Honohan has published widely on macroeconomics and monetary and financial sector issues ranging from exchange rate regimes and purchasing-power parity to migration, cost-benefit analysis, and statistical methodology. Based in Dublin, he is a Member of the Royal Irish Academy and a Research Fellow of the Center for Economic Policy Research, London. He coedited *Financial Liberalization: How Far, How Fast?* (Cambridge University Press, 2001) with Gerard Caprio and Nobel Laureate Joseph Stiglitz.

Luc Laeven is a Senior Financial Economist at the World Bank. He has participated in several financial and private sector operations of the World Bank, focusing on the development of banking systems and corporate sectors. His research focuses on international banking and corporate finance issues and has been published in numerous books and academic journals, including the *Journal of Finance*, the *Journal of Money, Credit, and Banking,* the *Journal of Financial Intermediation*, and the *Journal of Banking and Finance*. He is an Extramural Fellow at Tilburg University and a Research Affiliate in the Financial Economics Programme of the Centre for Economic Policy Research in London.

Systemic Financial Crises

Containment and Resolution

Edited by

PATRICK HONOHAN
The World Bank

LUC LAEVEN
The World Bank

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Contents

Contributors

Charles W. Calomiris
Columbia University

Gerard Caprio
The World Bank

Stijn Claessens
University of Amsterdam and CEPR

Patrick Honohan
The World Bank and CEPR

Daniela Klingebiel
The World Bank

Luc Laeven
The World Bank and CEPR

Carl-Johan Lindgren
Independent private consultant

Joe Peek
University of Kentucky

Rafael Repullo
CEMFI and CEPR

Eric Rosengren
Federal Reserve Bank of Boston

David Smith
Federal Reserve Board

Per Strömberg
University of Chicago, NBER, and CEPR

Adrian Tschoegl
The Wharton School, University of Pennsylvania

Foreword

Gerard Caprio
The World Bank

Citizens around the world need and demand the opportunity for economic advancement. Many possess entrepreneurial skills that would be the envy of those in high-income countries, as witnessed by their ability to survive in wretched conditions. Recent research, a part of which was contributed by the World Bank, has clearly demonstrated that finance is critical to economic development. One factor that keeps poverty elevated and growth depressed is the absence of *reliable* financial services. Many developing countries' financial systems are fragile and periodically are beset by crises – events that set back development, leave banks reluctant to lend, and leave citizens wary of entrusting their savings to the official banking sector. This diversion of savings into inefficient forms is likely one of the great and unmeasured costs of banking crises. Banking crises capture headlines when they are overt, leading to runs on individual banks or even on the entire banking system in the form of capital flight, often a sharp reduction in credit (a "credit crunch"), and a concomitant significant reduction in the standard of living. But episodes of systemic bank insolvency often occur without an overt crisis, yet the effects on economic development are just as damaging.

Although the World Bank's role in finance focuses on developing the infrastructure needed to support a robust financial sector, the Bank also is involved in member countries in times of hidden or overt financial crises. Although the role of providing short-term liquidity support clearly is the domain of the International Monetary Fund, the Bank's expertise is brought to bear in helping authorities to build a sound financial system. Quite often, an overt crisis can marshal support for fundamental policy changes in the financial sector, hence the Bank's involvement.

Financial crises have occurred periodically for as long as banks have existed. Charles Kindleberger, in his classic volume *Manias, Panics, and Crashes*, argued that each generation had to have its own financial crisis; recent events suggest that he may have been conservative in his estimates. Crises recur in part because people forget the lessons from the last one, just as in every stock market boom claims are heard that "this time is different." Although much can be done to make financial systems more robust – in effect, to reduce the magnitude of crises, as well as their frequency – it is critical that authorities be prepared for crises when they occur.

The purpose of this book is to draw on the combination of research and first-hand crisis experience to catalog lessons on a variety of issues that regularly arise in crises: containment, resolution, and broader structural reform. Policy makers would be advised to read this volume now, as it reveals areas for reform that, if enacted in time, will make handling the next crisis easier. But more than most, the present study needs to remain on their bookshelf for the next crisis, as it contains valuable lessons fresh from a wave of crises in the last decade.

This volume is part of the World Bank's ongoing effort to disseminate best practices in various aspects of financial sector reform, and it is hoped that it will be of value to policy makers and to those who study developing countries. In keeping with the usual practice, the views expressed here should be regarded as personal, and they do not necessarily reflect those of the Bank, its shareholders, or member country authorities.

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