The output and fiscal impact of financial crises.

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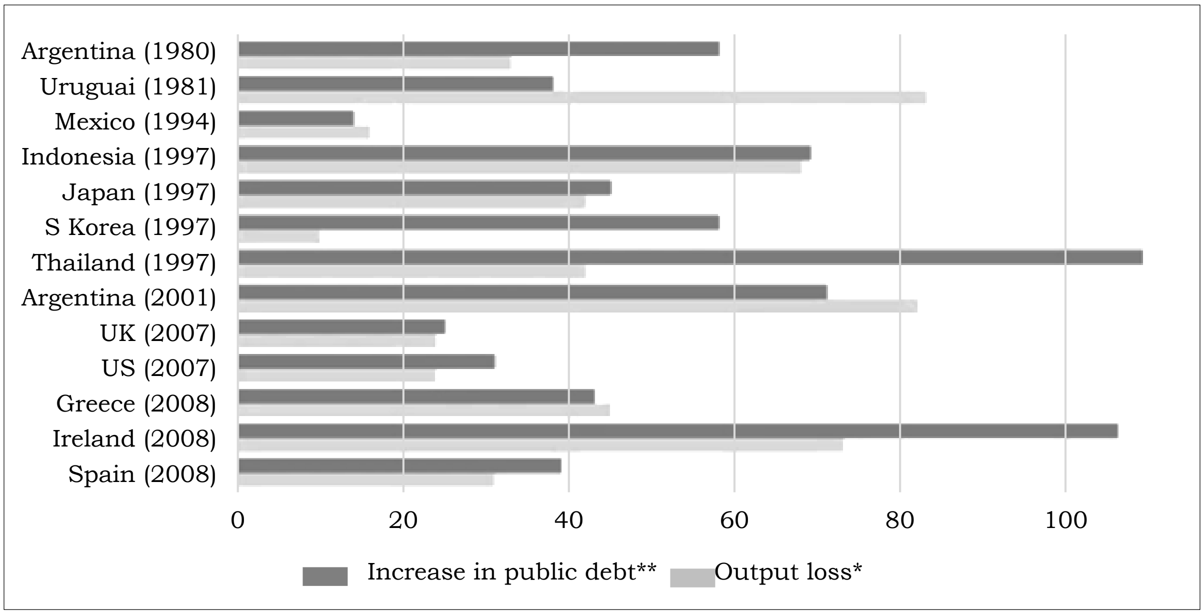
Financial crises are a major source of global welfare loss. The world is still reeling from the great financial crisis of 2008, with some European countries that still haven't reached their pre-crisis GDP level.

Recessions, almost by definition, bring economic pain. But financial crises are different. In a typical recession, asset prices fall or companies see opportunities when they believe that the economy will rebound. But amidst a financial crisis, even if companies foresee opportunities they cannot finance them. Economic activity slows to a crawl. The economy cannot recover unless the financial system comes back to life. Figure 1 illustrates that.

The figure shows the increase in public debt and output loss related to the most important financial crisis since 1980. As we can see, the usual scenario is for a financial crisis to increase public debt and decrease GDP by more than 20%. The only exceptions are the Mexican crisis in 1994 and the South Korean public debt in 1997. Extreme cases are Thailand in 1997 and Ireland in 2008. In both cases public debt more than doubled and output loss was over 40%.

Figure 1. Change in output and debt after banking crisis (% points of GDP)



Notes. Start of crisis in brackets. * Cumulative difference between actual and trend GDP, three years after start of crisis. ** Change between year prior to crisis and third after the crisis.
Source: Financial Times and IMF Systemic Crisis Database.

On chapter 5 we describe the links between the financial and real side of the economy and detail how commercial banks are fundamental entities in connecting the two. Financial crises break or stress these connections. Then, governments intervene to bring things back to normal. There is not a case of a financial system that was left to its own devices, among the cases in figure 1. Bailouts, partial or total, happened in all the cases.

An overlooked aspect of policymaking is the fact that avoiding financial crises is one of the most important jobs of public authorities.

Questions for discussion:

1) Choose one of examples of financial crises in Figure 1. Research the event and answer the following questions (explaining your reasoning):
    a. Did the crisis originate in the country or did it happen because of a contagion effect?
    b. How long did it last and what were the major economic consequences?
    c. What were the government's responses to the events?
    d. Do you believe that the government dealt correctly with the aftermath of the crisis and the subsequent revised regulatory framework?
2) Figure 1 presents some support for the "too big to fail" argument for bailing out banks during a financial crisis. Explain the regulation/deregulation tradeoffs and your opinion regarding the bailing out of commercial banks during a financial crisis.