Press points for Chapter 4: ***What's the Damage? Medium-term Output Dynamics After Financial Crises***

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Key points

- **Typically, banking crises have a long-lasting impact on the level of output although growth eventually recovers. Lower employment, investment, and productivity all contribute to sustained output losses. However, there is substantial variation across countries.**

- **Initial conditions have a strong impact on the size of the ultimate output loss. Also, short-run macroeconomic stimulus and structural reform efforts tend to be associated with lower output losses.**

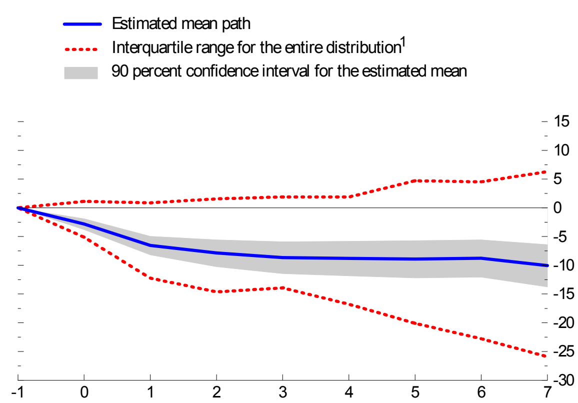
- **The findings suggest that forceful macroeconomic policy response so far may mitigate the losses. Implementing structural reforms could also help to limit output losses.**

Chapter 4 presents new evidence on medium-term output performance following financial crises. It looks at the medium-term output dynamics after 88 banking crises over the past four decades in a wide range of countries. The chapter also seeks to explain the substantial variation in medium-term outcomes, relating it to pre-crisis conditions and post-crisis policies.

For the average country, the output level is still around 10 percent below its pre-crisis trend seven years after the crisis, although there is a large variation in outcomes across crisis episodes. This result holds for both advanced and emerging economies. The good news is that, on average, banking crises do not seem to permanently decrease medium-term output growth, although the variation across country experiences is again substantial.

Output Evolution after Banking Crises

(Percent of precrisis trend; mean difference from year t = – 1; first year of crisis at t = 0; years on x-axis)

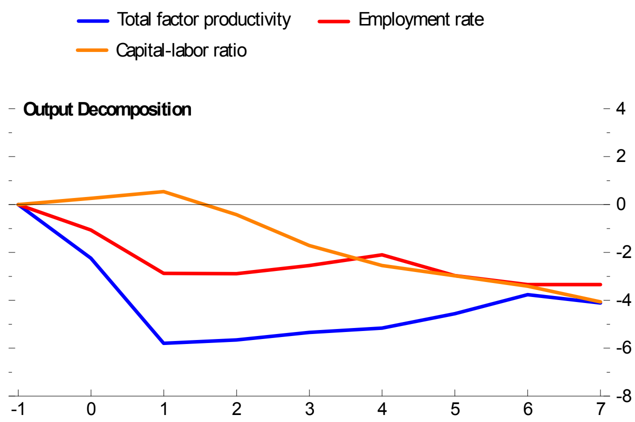


Sources: World Bank, *World Development Indicators;* and IMF staff calculations.
[1] The Interquartile range indicates the middle 50 percent of all crises.

The depressed path of output post-crisis results from reductions of roughly equal proportions in the employment rate, the capital-to-labor ratio, and productivity. In the short run, the output loss is mainly accounted for by total factor productivity, but the level of total factor productivity recovers somewhat toward its pre-crisis trend over the medium run. In contrast, capital and employment suffer enduring losses relative to trend. This is because the crisis tends to depress investment as the supply of credit becomes more limited. Also, the typically large increase in the actual unemployment rate tends to persist for a long time, as the crisis implies a substantial reallocation of labor across sectors and working skills may be eroded.

Output Decomposition

(Percent of precrisis trend; mean difference from year t = – 1; first year of crisis at t = 0; years on x-axis)



Sources: Bosworth and Collins (2003); World Bank, *World Development Indicators;* and IMF staff calculations.

Initial conditions have a strong influence on the size of the output loss. What happens to short-run output is a reliable predictor of the medium-term outcome. Also, a high pre-crisis investment share is a good predictor of large medium-term output losses.

The medium-run output loss is not inevitable. Some countries succeed in avoiding it, ultimately exceeding the pre-crisis trajectory. Although post-crisis output dynamics are hard to predict, the evidence suggests that economies that apply macroeconomic stimulus in the short run after the crisis tend to have smaller output losses over the medium run. There is also some evidence that structural reform efforts are associated with better medium-run outcomes, although there is certainly no “one size fits all” when it comes to establishing the right policy after the crisis.

The analysis has sobering implications for the medium-term output prospects in economies that have suffered recent banking crises. The forceful macroeconomic policy response so far, in the form of substantial fiscal and monetary stimulus, should help to mitigate the crisis’ impact on output. Nevertheless, remaining concerns about losses underscore the importance of implementing reforms to help raise medium-term output and facilitate the shift of resources across sectors following the crisis.