African Systemic Financial Crises

Cedric Mbeng Mezui, Stefan Nalletamby and Hugues Kamewe*

Introduction

This brief draws from the global database on systemic financial crises (Laeven and Valencia, 2010) to examine the situation in Africa over the period 1970-2009 and inform current effort to strengthen financial systems on the continent. It emphasizes on key factors that have been important in previous crisis periods but also points to possible gaps in conventional wisdom.

In general, economies that have experienced financial crises are characterized by a mix of weaknesses such as: balance sheet fragilities, inadequate regulation and supervision, negative fiscal balance, current account deficit and a perceived failure to mobilize an effective policy response. These issues and their interaction influenced both the beginning of the crises and the way they unfolded. The specific combination of these elements varies across crises. In some cases, balance sheet fragilities in the financial sector have been the cause; while in others public debt dynamics have been the main center of concern.

The theory of systemic financial crises

The literature considers that a systemic risk is the threat of disruption to the flow of financial services that is caused by an impairment of all or parts of the financial system. It admits that an entity is systemic if its failure causes widespread distress, either as a direct impact or as a trigger for broader contagion. Some countries focus on the impact on the financial system, while others consider the ultimate impact on the real economy as key. From the view of the International Monetary Fund (IMF) an assessment of “systemic importance” requires the identification of potential channels of systemic risk in the financial system. These are components that are critical to the system as a whole and are not easily substitutable (banks, clearing, payment and settlements systems); direct inter-linkages between components; common or correlated exposures and indirect linkages among components.

In the context of financial systems, there are strong linkages between currency, banking, and debt crises, especially for emerging and developing economies hit by all three at the same time. Reinhart and Rogoff (2010a, b) suggest the subsequent causality: private-sector defaults precede banking sector crises that coincide with or precede public debt defaults1. At the same time, the opposite may also occur with public debt defaults leading to banking crises either when banks are the main owners of government debt or the government accumulates large payment areas ending up weakening the private sector. A

* Cedric Mbeng Mezui, Stefan Nalletamby and Hugues Kamewe are respectively Senior Regional Financial Integration Expert, Partnership Coordinator, Making Finance Work for Africa (MF4A) and Consultant MF4A at the African Development Bank. The authors would like to thank Ms. Mupotola (Manager ONRI.2) and U. Duru (ONEC) for their comments and guidance.

1 For example the current Euro debt crisis.
banking (and/or currency) crisis may trigger a debt crisis, in which case the valued effect of debt crises on contemporaneous output growth could be seen as the lagged influence of banking (or currency) crisis episodes. It is particularly difficult to separate the effect of debt crises on real output. Banking and debt crises could also lead to currency crises. For example, third-generation crisis theory (Krugman, 1999) underlines the role of maturity mismatches and currency disequilibria in private (typically banking-sector) balance sheets as the core cause for the beginning of currency crises.

Evidence from the continent

We rely on information from the Laeven and Valencia database identifying 141 systemic crises (Banking, Currency and Sovereign debt) in Africa, from 1970 to 2009, as well as the occurrence of twin crises (banking and currency) or triple crises (banking, currency and debt) over 40 years among a panel of 50 countries.

The database indicates 44 banking crises; 71 currency crises; 25 sovereign debt crises; 22 twin crises (banking and currency) and 4 triple crises (banking, currency and debt). It appears that banking crises were most common in the first-half of the 1990’s, with a peak of 6 systemic banking crises starting in the year 1995. Currency crises were also frequent during the same period, with 19 currency crises starting in 1994 (among these the devaluation in the CFA franc zone: 13 countries). The early 80s were also characterized by 4 banking crises and 6 currency crises starting in 1983. Sovereign debt crises occurred in the early 1980’s, with a maximum of 4 debt crises starting in 1983 and 1991.

In total, 50 percent of banking crises are considered twin crises and 9% can be categorized as triple crises, using the Laeven and Valencia’s definition. The fourteen CFA franc countries count for 36% of banking crises; SADC countries count for 33% of currency crises, followed by CFA countries with 22.5%, North Africa with 10% and EAC with 7%. The CFA countries represent 36% of debt crises, followed by SADC with 28%. Mauritius is the only country that never encountered one of the mentioned crises during the indicated period while DRC is the country that experienced the most systemic crises: (3) banking crises (1983, 1991 and 1994) and (5) currency crises (1976, 1983, 1989, 1994 and 1999).

African banking crises tend to match with currency crisis, while they hardly concur with sovereign debt crises. In 50 percent of cases, the banking crisis corresponds with a currency crisis, but in only 9 percent of cases the banking crisis matches with a sovereign debt crisis.

Graph 1 Frequency of Systemic Financial crisis: 1970-2009

![Graph 1](source: constructed by authors based on Laeven and Valencia’s database.)

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2 Laeven and Valencia (2008): A systemic banking crisis occurs when: i) a country’s corporate and financial sector experience a large number of defaults; and ii) financial institutions and corporations face great difficulties repaying contracts on time. As a result, non-performing loans (NPLs) increase sharply and all or most of the aggregate banking system capital is exhausted.

A currency crisis is defined as a nominal depreciation of the currency of at least 30% that is also at a 10% increase in the rate of depreciation compared to the year before.

Twin crisis shows banking crisis in year t and currency crisis during [t-1, t+1]; Triple crisis shows banking crisis in year t and currency crisis during [t-1, t+1] and debt crisis during [t-1, t+1]

3 Without Bissau Guinea.
The Causes of banking crises

Evidence suggests the prevalence of crises in countries with pronounced government ownership of banks. For example, the database indicates that government ownership explained directly more than 30% of the banking crises, particularly in CFA franc zone. During the 80s in the WAEMU, 30 banks encountered structural weaknesses (Servant, 1991), among them 27 collapsed. State-owned banks represented on average 56% weighted as follows: 50% in Benin, 100% in Burkina-Faso; 75% in Cote d’Ivoire, 67% in Niger; 43% in Senegal and, 25% in Togo (Powo Fosso, 2000). In CEMAC, during the same period, 9 over 40 banks collapsed. Out of the 31 remaining, only one complied with standard regulations, 20 had precarious balances and 10 were insolvent. Three reasons are often considered the origins of the crises in CEMAC: Interventionist monetary policy, predominance of state-owned banks, and weak prudential regulations (Mathurin Tchakounte, 2009).

What comes out from our analysis of African financial crises is that there are strong linkages between currency, banking, and debt crises. However, common underlying causes prior to banking crises include:

(i) Weak macroeconomic background: negative fiscal balances, current account deficit, devaluation, high inflation and high interest rates; and
(ii) Structural weaknesses: inadequate regulation and supervision; poor governance; high nonperforming loans’ ratio; high Government ownership of banks, loss of value due to competition from new entries, contagion between banks; illiquidity (liabilities highly liquid but assets have longer maturity), insolvency (large shock to balance sheet relative to capital: large exposure or little capital).

Costs of Systemic banking crises

The database indicates that output loss from banking crisis (% GDP) is averaging 19% and the maximum is Niger with 122.7% (starting in 1983).

The growth sacrifice is measured by a lower real GDP growth rate (% of GDP). It’s averaging -2.3%, the minimum is 6.7% in Cape Verde (starting in 1993) and the maximum is -27.2% in Guinea-Bissau (starting in 1995).

The gross fiscal costs related with banking crisis averages around 10 percent of GDP, and can be as high as 25% of GDP in Cote d’Ivoire (1988), 17 percent of GDP in Senegal and Benin (1988).

Policy responses to systemic financial crises

Many approaches have been suggested to resolve systemic crises. Some have focused on reducing the fiscal costs of financial crises, others on controlling the economic costs in terms of lost output and on accelerating bank restructuring, whereas others pursued long term structural reforms.

There is no “one size fits all” approach to managing systemic banking crises. Strategies must be tailored to country conditions. The standard “model” of crisis management consists in:

- Containing the crisis: to stabilize the situation and restore public confidence;
- Bank restructuring: to restore the viability of financial system; improve the incentive structure (including avoiding moral hazard to the extent possible);
- Management of impaired assets: resolution of NPLs;
- Re-intermediation: once the banking system has been stabilized, authorities will need to turn to strengthening the financial system and fostering re-intermediation; and
- Regulation and Supervision: Strengthening regulatory frameworks and supervisory capacities is a pivotal reform.
agenda. Greater attention should be paid to the monitoring of risks outside the banking sector.

**Lessons learnt from systemic crises resolution**

- Political will is essential for successful crisis management;
- Having a single accountable authority can facilitate crisis management;
- Speed of intervention is essential;
- A coherent and comprehensive package of measures should be implemented;
- In addressing the problems, there is a need to look beyond basic performance indicators (profitability, liquidity, capitalization and NPLs) since these indicators are going to turn only when it is too late;
- Watch daily movements of the main financial prices that provide the propagation mechanism for contagion effects, namely exchange rates and stock prices;
- Aggressively regulate and supervise financial systems to ensure that banks manage risks prudently; to ensure there is accountability, transparency and responsibility in banking operations;
- Erect an incentive structure for sound corporate finance to avoid high leverage ratios and excessive reliance on foreign borrowing;
- Understanding the financial linkages across various financial intermediaries is also important;
- Recapitalization with government funds may be justified in some circumstances;
- Ensuring macroeconomic sustainability is essential; as well as
- Restoring confidence and trust in the system.

**References**