

Costs of financial instability, household-sector balance sheets and consumption

Ray Barrell^a, E. Philip Davis^{a,b,*}, Olga Pomerantz^a

^a NIESR, 2 Dean Trench Street, Smith Square, London SW1P 3HE, United Kingdom

^b Brunel University, Uxbridge, Middlesex UB8 3PH, United Kingdom

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Abstract

Extant work on costs of financial instability focuses on fiscal costs and declines in aggregate GDP following banking crises. We estimate effects of banking and currency crises on consumption in 19 OECD countries, showing consumption plays an important role in the adjustment following a crisis, and effects are not captured solely by the impact of crises on standard consumption determinants, income and wealth. Additional effects, attributable to factors such as time-varying confidence, uncertainty and credit rationing, are aggravated by high and rising leverage, despite financial liberalisation easing liquidity constraints. High leverage implies that banking crises taking place now could have greater incidence than in the past.

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0. Introduction

Whereas there is an extensive and growing literature which focuses on *predicting* the incidence of financial instability (in respect of both banking and currency crises), the literature on the *costs* of financial instability – the key reason for concern in respect of financial turbulence – is relatively sparse. Most of the literature that does exist is focused either on fiscal costs or aggregate measures of losses in GDP from banking crises, rather than the subcomponents of GDP or including currency

* Corresponding author. Tel.: +44 1865 266643.

E-mail addresses: rbarrell@niesr.ac.uk (R. Barrell), philip.davis@brunel.ac.uk, e-philip.davis@msn.com (E.P. Davis), opomerantz@niesr.ac.uk (O. Pomerantz).

crises. It is also commonly focused on a global sample, or solely on emerging market economies but rarely on OECD countries alone. Analysis of subcomponents such as investment and consumption is highly relevant for assessing the incidence of crises and devising policy measures to neutralise their adverse impact. Hence, for example, any tax or other fiscal changes designed to cushion the fall in GDP would need to be appropriately directed to the relevant type of expenditure. Clearly, which subcomponents of GDP crises affect will depend partly on the impact of the crisis itself on their determinants, which for consumption are real incomes and net financial wealth. But there are also likely to be effects arising from factors such as uncertainty, confidence and credit availability whose impact is likely to go beyond the “normal” response of consumption to these variables.

Impacts of crises on consumption may also vary by type of country and over time. If there are such differences, they may be explicable by structural factors that have evolved over time or vary across countries, e.g. depending on size. The impacts of crises on expenditure components may change over time as financing behaviour and expectations about liquidity respond to financial deregulation. The effect may also vary with balance sheet structure, where growing leverage has been a marked feature of household sectors in recent years. In this context, this article seeks to assess address these issues by measuring the costs of financial instability – in terms of both banking and currency crises – for 19 OECD countries in respect of consumption, the largest component of GDP.

The article is structured as follows. First we summarise some recent estimates of the costs of financial instability. We then estimate baseline consumption functions for all 19 countries, and then break the 19 countries we study into G-7, small open economies and the Scandinavians to see if there are differences across countries. We also investigate whether the financially more liberalised 1990s look different from the preceding period. Using these groups throughout, we divide effects of crises between those due to standard consumption determinants and those left unexplained by our equations. We also assess whether the scope of these unexplained effects varies across types of crisis and has increased with rising household leverage.

1. Measuring costs of banking crises

Whereas there are many studies which estimate the causal factors underlying financial instability (see the reviews in [Bell and Pain \(2000\)](#) and [Demirguc Kunt and Detragiache \(2005\)](#)), those which estimate the costs are rather less common. A key paper is that by [Hoggarth and Sapporta \(2001\)](#), which adopts a number of approaches to measuring banking crises’ impact and surveys extant work. In estimating the magnitude of such costs, a first issue is to assess the timing of a banking crisis. A crisis may be pinpointed as a period when much or all of the banking sectors’ capital is exhausted (systemic crisis) or when there are problems such as bank runs, bank closures, mergers or government take-overs (borderline crisis).

Having adopted a crisis definition, most studies of output losses due to banking crises have sought to measure them as differences from trend in terms of output growth. In [IMF \(1998\)](#) and [Aziz et al. \(2000\)](#) costs were measured relative to the 3 years preceding the crisis, for [Bordo et al. \(2001\)](#) it was relative to the previous 5 years. The end of the crisis is then defined as being when output growth returns to trend. [Hoggarth and Sapporta \(2001\)](#) note that this method may be less accurate than an approach which sums the *levels* of output losses relative to trend, where trend is measured over 10 years prior to the crisis. Levels allow more sensitively for output losses than do growth rates for crises that last more than 1 year. This is because the growth rate criterion would say the crisis is over as soon as the growth rate gets back to trend, while actually there is an “integral” of output losses that continues to build up until the *level* of growth gets back to its

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