Journal of Financial Economics 111 (2014) 646–660

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Crises and confidence: Systemic banking crises and depositor behavior ☆

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ARTICLE INFO

Article history:
Received 20 December 2012
Received in revised form
4 April 2013
Accepted 6 May 2013
Available online 18 November 2013

JEL classification:
G01
G11
O16
D83

Keywords:
Systemic banking crises
Confidence
Deposit insurance
Reinforcement learning
Immigrants

ABSTRACT

We show that individuals who have experienced a systemic banking crisis are 11 percentage points less likely to use banks in the U.S. than otherwise similar individuals who emigrated from the *same* country but did not live through a crisis. This finding is robust to controlling for exposure to other macroeconomic events and to various methods for addressing potential bias due to migrant self-selection. Consistent with the view that personal experience plays an important role in decision-making, the effects are larger for individuals who were older and more likely to have had wealth entrusted to the banking system at the time of the crisis and for people who experienced crises in countries without deposit insurance.

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1. Introduction

Confidence in the stability of the banking sector is critical for financial markets to function effectively. In the wake of the recent global financial crisis, confidence in financial institutions fell dramatically in the U.S. and in other industrialized countries. Evidence of the decline in confidence included the reemergence of old-fashioned bank runs, with depositors lined up outside the doors of institutions like Indy Mac in the United States and Northern Rock in the United Kingdom, seeking to withdraw their savings from those failing institutions. "Crises … leave citizens wary of entrusting their savings to the official banking sector. This diversion of savings is likely one of the great and unmeasured costs of banking crises" (Gerard Caprio, 2005).

Despite the potential importance of confidence in determining the costs of a financial crisis and paths to

☆ This paper has benefitted from the comments of an anonymous referee as well as seminar participants at Boston University, the Federal Reserve Banks of Boston and Chicago, the University of Chicago, the International Monetary Fund, IUPUI, Wellesley College, and Yale University. We thank Dan Aaronson, Joe Altonji, Sandeep Baliga, Kristin Butcher, Jeff Campbell, Eliana La Ferrara, Ulrike Malmendier, Mark Rosenzweig, and Paola Sapienza for helpful comments. We are grateful to Nathan Marwell for exceptional research assistance. The views presented here are those of the authors and not necessarily those of the Federal Reserve Bank of Chicago, the Federal Reserve System or the U.S. Census Bureau. This research was carried out at a U.S. Census Bureau Research Data Center facility. The results and conclusions of the research are those of the authors and do not indicate concurrence by the Census Bureau. The results have been screened to avoid revealing confidential data.

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0304-405X/$ - see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.jfineco.2013.11.002

recovery, its implications for behavior remain underexplored.[1] We examine the impact of living through a systemic banking crisis on an individual's future interactions with banks and show that crises lower financial market participation. We estimate the impact of crises on confidence in banks by examining the financial decisions of otherwise similar individuals who differ in their exposure to financial crises. We do this by combining data on the investment behavior of immigrants in the U.S. with measures of their exposure to systemic banking crises prior to their arrival in this country.

The goal of the analysis is to determine how exposure to banking crises influences banking behavior in the U.S., controlling for individual and country characteristics. If episodes of financial instability have long-lasting effects on confidence in banks and if confidence matters for behavior, then individuals who have experienced a crisis could make different financial choices than otherwise similar individuals who have not lived through a crisis. In particular, reduced confidence could manifest itself in lower usage of U.S. financial institutions among individuals who had experienced a systemic banking crisis prior to arriving in the U.S.

Recent research has shown that levels of confidence and trust influence financial decisions generally (Guiso, Sapienza, and Zingales, 2004, 2008). In addition, there is growing evidence that confidence in financial institutions varies with economic and financial conditions. For example, confidence in banks appears to have declined significantly since the onset of the 2008 global financial crisis. Stevenson and Wolfers (2011) demonstrate that confidence in U.S. financial and nonfinancial institutions is higher when economic conditions are good. They also show that the recent global financial crisis has led to decreased trust in banks in many industrialized countries and that confidence has decreased more in places where unemployment increased more. Mudd and Valev (2009) provide evidence that the Bulgarian financial crisis of 1996 lowered confidence in Bulgarian banks, particularly among those who lost money as a result of the crisis.

In this study, we examine how exposure to a systemic banking crisis lowers confidence in financial institutions in a way that is manifested in subsequent banking behavior. Our work is related to research that investigates how exposure to certain economic conditions influences future attitudes and behavior. For example, Malmendier and Nagel (2011) show that an individual's early exposure to stock and bond returns impacts subsequent investment behavior, and Giuliano and Spilimbergo (2009) find that individuals who grow up during recessions are more likely to support government redistribution and to believe that luck has more to do with success than effort. Graham and Narasimhan (2005) find that corporate managers that have lived through the Great Depression in the U.S. choose a more conservative capital structure with less leverage, even after economic conditions improve.[2] Fernández (2011) provides an excellent summary of additional work in this area.

Focusing on the investment behavior of individuals who have migrated to the U.S. offers distinct advantages for understanding the role of confidence in financial decision-making. First, by studying investment decisions in a common institutional, economic, and financial environment, we minimize the potential impact of confounding cross-country differences, including the success and credibility of post-crisis reforms. Examining investment decisions in the U.S. also helps to isolate factors that influence the demand for financial products, rather than their supply, since the supply of financial services in the U.S. is likely to be independent of banking crises in other countries. In addition, because individuals from the same country vary in their exposure to crises, we can include country-of-origin fixed effects in our empirical specifications. By doing this, we hold constant country-level variation in economic, financial, institutional, and cultural factors and compare individuals from the same country who have or have not experienced a crisis.[3] We further isolate the impact of exposure to a banking crisis on confidence by including wealth and income in the analysis and, thereby, control for the potential direct effect of the crisis on these variables.[4]

Our findings indicate that experiencing a systemic banking crisis has important effects on financial decisions. Individuals who have lived through a systemic banking crisis are 11 percentage points less likely to have a checking account in the U.S. We focus on checking accounts because they are the most common means by which individuals entrust funds to banks, so they provide an excellent way to benchmark the effects of confidence. Nearly 90% of U.S. households have a checking account, according to recent data from the Survey of Consumer Finances, whereas only 48% have a savings account. The adverse impact of living through a banking crisis on checking account ownership persists when we include controls for having experienced a recession or a currency crisis. The results cannot be accounted for by legal status or issues related to unmeasured wealth.

After about two decades of residence in the U.S., immigrants' behavior ceases to reflect the impact of experiencing a crisis, according to our estimates. Consistent with the importance of direct experience, hypothesized in the reinforcement learning literature, we also find that living through a crisis has a greater impact on individuals who

[1] Researchers have investigated the consequences of banking crises for firms. Dell'Ariccia, Detragiache, and Rajan (2008) find that growth in externally dependent sectors tends to be lower during banking crises. Kroszner, Laeven, and Klingebiel (2007) find that firms that are more dependent on external finance perform relatively worse during banking crises in countries with well-developed financial systems.

[2] In related work, Kaustia and Knüpfer (2008) show that initial public offering (IPO) returns experienced by individual investors influence their future investment in IPOs; and Choi et al. (2009) provide evidence that individuals over-extrapolate from their personal experience when making savings decisions.

[3] A number of studies demonstrate that country-of-origin characteristics impact a wide variety of immigrant and immigrant offspring behavior, including savings, stock market participation, banking, and fertility. See, for example, Carroll, Rhee, and Rhee (1994, 1999), Osili and Paulson (2008a, 2008b), and Fernández and Fogli (2009).

[4] For example, McKenzie (2004) documents substantial and widespread declines in real incomes in the wake of the 2002 Argentine financial crisis.

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