



The real effect of banking crises [☆]

Giovanni Dell’Ariccia ^{a,*}, Enrica Detragiache, Raghuram Rajan

^a IMF, 700 19th Street NW, Washington, DC 20431, USA

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Abstract

Banking crises are usually followed by low credit and GDP growth. Is this because crises tend to take place during economic downturns, or do banking sector problems have independent negative real effects? If banking crises exogenously hinder real activity, then sectors more dependent on external finance should perform relatively worse during banking crises. The evidence in this paper supports this view. The differential effects across sectors are stronger in developing countries, in countries with less access to foreign finance, and where banking crises were more severe. Robustness checks include controlling for recessions, currency crises, and alternative proxies for bank dependence.

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1. Introduction

Banks are thought to be central to business activity. Therefore, when they experience financial distress, governments usually come to the rescue, offering emergency liquidity and various forms of bailout programs. The case for generous bank support, however, is murky for a number of reasons. First, we have the standard identification problem: if bank distress and economic distress occur at the same time, how can we tell the direction of causality? Second, if bank distress does in fact impair economic activity, under what circumstances is this likely to be most harmful? Third, while interventions may save banks, they may not necessarily prevent the distressed banks from

[☆] The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the IMF, its Executive Directors, or the countries they represent.

* Corresponding author. Fax: +1 202 589 8135.

E-mail address: gdellariccia@imf.org (G. Dell’Ariccia).

affecting economic activity. So do any interventions prevent banks from impairing economic activity, and if so, which ones are they? Fourth, how do the costs of intervention weigh up against the benefits? This paper focuses on the first two questions, shedding limited light on the last two issues.

Empirical studies show that credit to the private sector and aggregate output do in fact decelerate during banking crises (see, for example, Kaminsky and Reinhart, 1999; Eichengreen and Rose, 1998; Demirgüç-Kunt et al., 2006). However, this is not necessarily evidence that banking problems contribute to the decline in output: first, the same exogenous adverse shocks that trigger banking problems may also cause a decline in aggregate demand, leading firms to cut investment and working capital and, ultimately, demand for bank credit. These same shocks may also cause a temporary increase in uncertainty, leading firms to delay investment and borrowing decisions. In addition, adverse shocks might hurt borrower balance sheets and exacerbate the effects of asymmetric information and limited contractibility, prompting banks—even healthy ones—to curtail lending to riskier borrowers (“flight to quality”) or raise lending spreads. To summarize, output and bank credit are likely to decelerate around banking crises even in the absence of a feedback effect from bank illiquidity and insolvency to credit availability.¹ To identify the real effects of banking crises it is necessary to sort out this joint endogeneity problem.

Problems of joint endogeneity are familiar in studies of whether finance matters to the real economy. They are central to the literature on financial development and growth (Levine, 2005) and to the work on whether financial market imperfections worsen economic downturns (the so called “credit channel” literature). To test whether banking crises have real effects, we adopt the “difference-in-difference” approach used by Rajan and Zingales (1998) to study the effects of finance on growth.² Our premise is that, if industries more dependent on external finance are hurt more severely after a banking crisis, then it is likely that banking crises have an independent negative effect on real economic activity. Using panel data from 41 countries from 1980 to 2000, we test whether more financially dependent industries experienced slower growth in banking crisis periods, after controlling for industry-year, country-year, and industry-country fixed effects. This profusion of dummy variables controls for all possible time specific, country specific, and industry specific shocks that may affect firm performance, thereby avoiding the usual difficulties of choosing an appropriate set of control variables.

In Rajan and Zingales (1998) industry dependence on external finance is measured by the fraction of investment not financed through retained earnings. We use the same index in our main specification.³ As an alternative measure of bank dependence, we use average establishment size in a sector, under the assumption that sectors dominated by small firms are more dependent on domestic bank financing.⁴ In the credit channel literature, identification based on firm size has been used, for instance, by Gilchrist and Himmelberg (1995).

¹ There are also measurement issues. Specifically, changes in the aggregate stock of real credit to the private sector are not a good measure of the flow of credit available to the economy, especially around banking crises. The stock may fall because a jump in inflation erodes the value of nominal contracts, or because restructuring operations transfer non-performing loans to agencies outside the banking system. On the other hand, a devaluation increases the domestic currency value of foreign-currency denominated debt (Demirgüç-Kunt et al., 2006).

² The “difference-in-difference” methodology has also been used in a variety of related problems (see, for example, Cetorelli and Gambera, 2001; Beck, 2003; and Bonaccorsi di Patti and Dell'Arìccia, 2004).

³ For several countries in our sample banks are overwhelmingly the main (and often the sole) source of external capital for firms. On average, in our sample the stock of bank credit is about 7 times larger than equity market capitalization.

⁴ An establishment is better thought of as a plant rather than a firm. In general, the majority of firms in any sector consist of single plant firms, so there will be a strong correlation between establishment size and firm size.

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