1

Financial Stability and Economic Growth

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1.1 Introduction

The relationship between the development of a country’s financial sector and its rate of economic growth has been studied in depth. However, few studies have tried to explain how the link between financial development and economic growth works during periods of financial instability. Bauducco, Buliř, and Čihák (2008), Hakkio and Keeton (2009) and Carlson et al. (2009) have recently studied the effects of financial stress on economy performance. They have pointed out that there are three different channels through which financial instability can affect the relationship between finance development and economic growth.

The first channel is an increase in uncertainty about the fundamental value of assets and the behaviour of investors during periods of financial instability. Since these two sources of uncertainty are frequently followed by increases in the volatility of asset prices, this makes firms more careful about investment decisions until the uncertainty has disappeared. Additionally, households tend to cut back their spending in times of financial instability, since the uncertainty affects the expected value of their future wealth. As a consequence the reactions of these two agents produce a fall in economic output.

The second way in which financial instability can affect economic activity is by deteriorating borrowing conditions due to tightened credit standards (Lown et al., 2000). When financial institutions raise their minimum credit standards it becomes harder for borrowers to get funding, with a consequent negative effect on economic growth.

Another channel through which financial instability can lead to a slowing of economic growth is through an increase in cost for firms and households of financing spending. As Hakkio and Keeton (2009) have
noted, instability increases interest rates on business and consumer debt in the capital markets, making it more expensive for firms to raise funds by issuing new equity. Such an increase in the cost of finance can cause firms and households to cut back on their spending and, as shown above, this has a negative effect on economic growth.

Overall, the relationship between the size of a country’s financial sector and its rate of economic growth has been studied in depth, but the empirical evidence on the finance-growth nexus in periods of financial instability is much more limited and is not conclusive. Most of the previous approaches assume that financial development has a linear correlation with growth; however, several theoretical studies suggest that the dynamics of economic growth and the role of financial institutions as a determinant of this growth follow a nonlinear pattern (Trew, 2008 and von Peter, 2009). In this sense, nonlinearities may well be the reason for the failure to empirically and generally validate specific aspects of the finance-growth nexus such as the relationship between the size of a financial sector and its growth.

The aim of this chapter is to overcome these problems by considering how nonlinear and intertemporal relationships between the main variables may help explain how the finance-growth nexus works during periods of financial instability. To achieve this goal, we consider a threshold model specification extended to a multivariate framework, known as Multivariate Threshold Autoregressive model (MVTAR), developed by Tsay (1998).

The main contribution of this chapter is to show the validity of a nonlinear approach to test how financial instability affects the relationship between financial development and economic growth. Section 2 summarizes some theoretical contributions and previous empirical evidence. Section 3 describes the data. Section 4 introduces the methodology and explains the multivariate threshold model with special emphasis on the modelling of nonlinear effects of financial instability. Section 5 refers to the estimation procedure and presents the main results. The chapter ends in Section 6 with a brief summary of conclusions and a discussion of policy implications.

1.2 Literature review

The theoretical treatment on how financial intermediation could promote economic growth has been carried out via studies from many specific perspectives while some studies have provided a more general