Are the effects of financial market disruptions big or small?*

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Abstract

While episodes of financial distress are followed by large and persistent drops in economic activity, structural time series analyses point to relatively mild and transitory effects of financial market disruptions. We argue that these seemingly contradictory findings are due to the asymmetric effects of financial shocks, which have been predicted theoretically but not taken into account empirically. We propose and estimate a model designed to identify the (possibly asymmetric) effects of financial market disruptions, and we find that a favorable financial shock —an easing of financial conditions— has little effect on output, but an adverse shock has large and persistent effects. The 2007-2008 financial market disruption can explain a large fraction of the 10 percentage points gap between current GDP and its pre-crisis trend.

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