

Inflation in the Aftermath of Banking Crises

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Extended Abstract:

There has been a plethora of banking crises in the past decades. According to Laeven and Valencia (2013) there have been 147 systemic banking crises in 93 countries since the late 1970s. One of the main economic questions is what effects these financial crises have. Previous studies have mainly analysed the effects on GDP growth. However, there is still a gap in analysing the effect of banking crises on inflation. This study tries to fill this gap by employing a large panel data set on banking crises including countries from all over the world. Banking crises are captured by a dummy that takes on the value one for all years in which there was a banking crisis. These dummy variables are, however, only included as lagged explanatory variables in the estimations. A banking crisis likely affects variables like GDP growth. Thus, we only include the banking crisis dummy as a lagged variable. The empirical analysis confirms the conjecture that banking crises lead, after several years, to higher inflation rates. After controlling for other causes of inflation we find an economically and statistically significant impact of banking crises on inflation. Having experienced a banking crisis two years ago leads, on average, to an increase in the inflation rate by 5.47 percentage points holding everything else constant. Furthermore, the study employs a two stages least squares approach (2SLS) to account for possible reverse causality problems. This is motivated by the empirical literature arguing that high inflation increases the likelihood of banking crises. The 2SLS estimations show that the coefficients for the dummy variables for having experienced banking crises in the past are still positive and statistically significant when banking crises are treated as endogenous. Thus, the results stand even if we control for possible endogeneity. In other estimations we also treat GDP growth as endogenous variable as there is some evidence that inflation has an adverse impact on GDP growth. The results are virtually the same when we also use an instrumental variable for GDP growth. Finally, we employ a dynamic panel data model. There is good reason to believe that there is some persistence in inflation rates. In this case, the Arellano Bond estimator for the dynamic panel data models (difference GMM estimations) is employed. Here we just include the inflation rate of last year to account for inflation inertia. The instrument for the lagged inflation rate is the inflation rate lagged by two periods. A further step is then to also instrument the banking crisis variable in this model. The results of the GMM estimates confirm the previous results. Banking crises lead, on average, to higher inflation rates after a few years. In the dynamic panel model, this effect is larger both in economic and statistical terms. Thus, there seems to be some evidence that countries that have experienced a banking crisis tend to have higher inflation rates in the medium term when controlling for several other causes of inflation.

JEL: G01, E31, E52, E58

Keywords: Banking Crises, Inflation, Determinants of Inflation

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