On Financial Risk, Growth, and Long-Run Risk*

Jesus Fernandez-Villaverde[†] Pablo A. Guerron-Quintana[‡] Ryo Jinnai[§]
Munechika Katayama[¶]

Abstract

We document empirically that financial risk has a long-lasting impact on economic activity, leading to a permanent effect on the economy's trend. We propose a model featuring endogenous productivity, financial frictions, and financial risk to explain the data. In our model, both the financial and real sectors contract after an adverse financial risk shock because this shock has perverse effects on productivity. Furthermore, financial risk induces persistent movements in consumption, which leads to endogenous long-run risk.

*We thank Dongho Song and the staff members of the Banco de la Reserve del Peru and the Federal Reserve Banks of Cleveland and Kansas City for valuable discussions.

[†]University of Pennsylvania
[‡]Boston College and ESPOL
[§]Hitotsubashi University
[¶]Waseda University