Erica Marujo

"The Welfare Costs of Financial Shocks"

Abstract:
I measure the welfare effects of financial shocks as a percentage of consumption in a real business cycle model and compare it with the welfare costs of other types of shocks (e.g. productivity). In this model where firms use both equity and debt financing, financial shocks are modelled through the innovations in the probability of default, as a result of a tightening of firms' financing conditions. The results show that financial shocks explain a significant extent of the macroeconomic dynamics of real and financial variables observed during financial crises, including the events occurred during the recent 2008 financial recession. The findings also suggest that although the welfare costs imposed by financial shocks computed in this framework are small, their relevance as a source of disturbances in business cycles cannot be underestimated.