

# INTERNATIONAL CREDIT SUPPLY SHOCKS<sup>☆</sup>

Ambrogio Cesa-Bianchi<sup>†</sup>      Andrea Ferrero<sup>‡</sup>      Alessandro Rebucci<sup>§</sup>

December 18, 2017

## Abstract

House prices and exchange rates can potentially amplify the expansionary effect of capital inflows by inflating the value of collateral. We first set up a model of collateralized borrowing in domestic and foreign currency with international financial intermediation in which a change in leverage of global intermediaries leads to an international credit supply increase. In this environment, we illustrate how house price increases and exchange rates appreciations contribute to fueling the boom by inflating the value of collateral. We then document empirically, in a Panel VAR model for 50 advanced and emerging countries estimated with quarterly data from 1985 to 2012, that an increase in the leverage of US Broker-Dealers also leads to an increase in cross-border credit flows, a house price and consumption boom, a real exchange rate appreciation and a current account deterioration consistent with the transmission in the model. Finally, we study the sensitivity of the consumption and asset price response to such a shock and show that country differences are associated with the level of the maximum loan-to-value ratio and the share of foreign currency denominated credit.

**Keywords:** Cross-border claims, Capital Flows, Credit Supply Shock, Leverage, Exchange Rates, House Prices, International Financial Intermediation.

**JEL codes:** C32, E44, F44.

---

<sup>☆</sup>Prepared for the 2017 NBER International Seminar on Macroeconomics (ISOM). We would like to thank our discussants at the ISOM conference, Julian di Giovanni and Alan Taylor, as well as our discussants at other conferences, Anil Ari, Luca Dedola, Aitor Erce, Alice Fabre, Gaston Gelos, Gurnain Pasricha, John Rogers, Tim Schmidt-Eisenlohr, Michael Stein, and Jing Zhou, for their comments and useful suggestions. We have also benefited from comments by participants at the 18th Jacques Polak Annual Research Conference, CEBRA 2017 Annual Meeting, 2017 NBER ISOM, CEBRA Boston Policy Workshop, 2017 WFC, 2017 BGSE Summer Forum, 2017 ESSIM, XIX BCB Annual Inflation Targeting Seminar, Sils Macro Workshop, Korea-Keio-HKUST 2nd International Macro & Finance Conference, EMG-ECB Workshop on Global Liquidity, 2016 EEA Meetings, HKCU-HKMA Conference on Real Estate and Financial Stability, 4th Workshop in Macro Banking and Finance, SF Fed-HKCU Conference on International Finance, 2015 NYU Alumni Conference, and at seminars at the Bank of England, BIS Asia Office, University of Durham, Fed Board, the University of York, New York Fed, and San Francisco Fed, University of Oxford, University of Manchester, University of St. Andrews. Alessandro Rebucci thanks the Black & Decker Research Fund for partial financial support for this paper. The views expressed in this paper are solely those of the authors and should not be taken to represent those of the Bank of England.

<sup>†</sup>Bank of England and CfM. Email: [ambrogio.cesa-bianchi@bankofengland.co.uk](mailto:ambrogio.cesa-bianchi@bankofengland.co.uk).

<sup>‡</sup>University of Oxford and CfM. Email: [andrea.ferrero@economics.ox.ac.uk](mailto:andrea.ferrero@economics.ox.ac.uk).

<sup>§</sup>Johns Hopkins University Carey Business School and NBER. Email: [arebucci@jhu.edu](mailto:arebucci@jhu.edu).

# 1 Introduction

Capital inflows are expansionary and pose difficult challenges for policy makers—see, for instance, [Rey \(2013, 2016\)](#).<sup>1</sup> Historically, however, some economies have been more sensitive than others to the volatility of capital inflows, with emerging market economies standing out as particularly vulnerable (e.g. [Chari et al., 2017](#)).

What are the mechanisms through which capital inflows lead to macroeconomic booms? And what are the characteristics that account for the differences in sensitivity across countries? In this paper, we explore the role of asset price inflation and credit market characteristics. Our main finding is that the currency denomination of credit flows and loan-to-value ratios are associated with the strength of the consumption response to international credit supply shocks.

Figure 1 shows that capital inflows are expansionary and associated with large swings in asset prices.<sup>2</sup> The figure shows that, during a boom, cross-border banking claims and equity prices grow more than 10 percent per year in real terms. GDP, consumption, and house prices grow about 4-5 percent per year. The current account balance deteriorates significantly before reverting during the last year of the expansion. The real exchange rate appreciates during the last two years of the boom phase (both in real effective terms and vis-a-vis the US dollar), while the economy starts to slow down. Short term real interest rates are high throughout the boom phase and increase further during the last year.

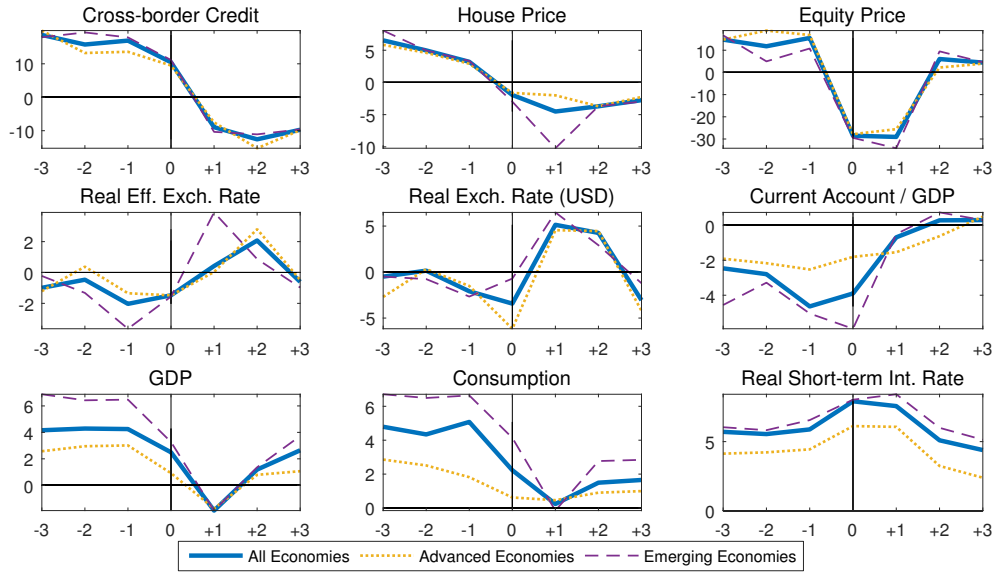
During the bust phase, these dynamics partially revert. Cross-border claims and house prices fall as fast as they grew during the boom phase for three years in a row. Equity prices drop very sharply for two consecutive years and, once they rebound, grow about half as fast as during the boom. GDP growth declines sharply and then resumes, but only at about a third of the pace exhibited during the boom years. Consumption slows down and then remains depressed. The current account deficit closes quickly and remains in a small surplus position. The real exchange rate depreciates sharply, and short term real interest rates decline, though remaining elevated.

---

<sup>1</sup>This observation provides a challenge for some theories. See, for example, [Blanchard et al. \(2015\)](#) on the Mundell-Fleming model and [Chari et al. \(2005\)](#) on sudden stops in the neoclassical growth model.

<sup>2</sup>See Appendix A and B for details on this event study and the underlying data.

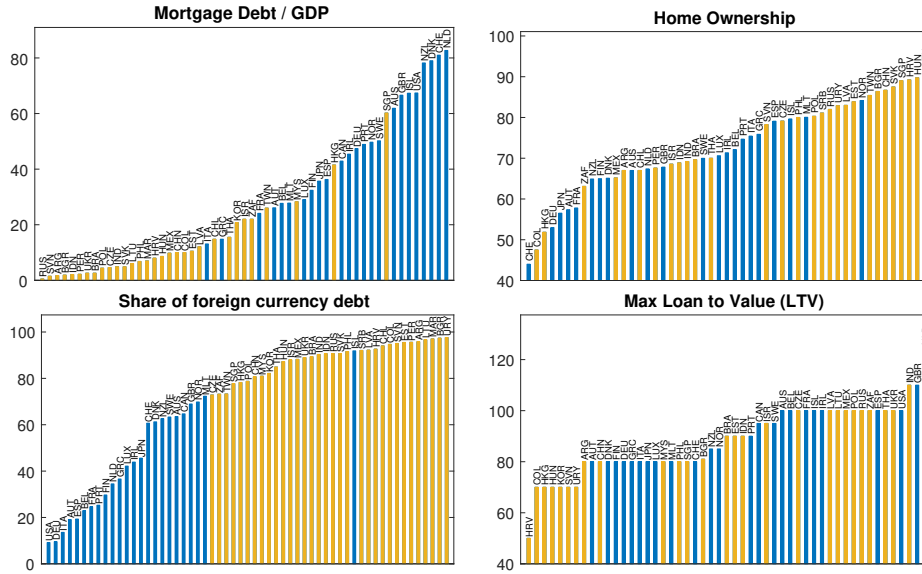
**Figure 1.** BOOM-BUST EPISODES IN CAPITAL FLOWS.



NOTE. The solid line plots the median pattern in whole cross section of countries in our sample, together with the median for advanced and emerging markets (dotted and dashed lines, respectively) across a set of boom-bust episodes in BIS cross-border claims, using a 6-year window, from three year before the peak to three years after the peak. In each panel, time 0 is the peak of the boom-bust cycle in cross-border bank claims (i.e., the last period of a boom in which cross-border bank claims display a positive growth rate), which is also depicted with a vertical line. All variables are expressed in percent. See Appendix A and B for more details of the identification of the episodes, including summary statistics, and the definition and data sources of the variables considered.

Not all countries behave alike. Figure 1 shows that emerging economies experience much larger and more persistent boom-bust cycles than advanced ones (dashed and dotted lines, respectively). This characterization of heterogeneity is still an oversimplification, as countries differ in ways that cannot always be reduced to the emerging market and advanced economies divide. For example, Figure 2 focuses on a few selected characteristics of credit markets. While emerging markets (lighter, yellow bars) tend to have shallower mortgage markets and higher shares of foreign currency debt than advanced economies (darker, blue bars), maximum LTV limits and home ownerships are distributed much more evenly. More generally, countries that are now member of the OECD, like South Korea and Mexico, in the past experienced some of the wildest capital flow gyrations. At the same time, more advanced economies like Ireland and

**Figure 2.** SELECTED COUNTRY CHARACTERISTICS.



NOTE. Each bar corresponds to a country. The lighter (yellow) bars are classified as emerging markets and the darker (blue) bars as advanced economies in Figure (1). See the data appendix for variable definitions and data sources.

other South European countries experienced deeper and longer-lasting financial crises than most emerging market economies during the global financial crisis.

In this paper, therefore, we will primarily study differences in experiences with capital inflows at the country level based on specific characteristics, as opposed to comparing country-groupings formed from the outset, focusing on variables that have a counterpart in a fully specified model of international borrowing and lending to help the interpretation of the empirical findings.

Traditionally, the analysis of capital flows and their impact on the macroeconomy distinguished between “push” and “pull” factors (Calvo et al., 1996). The former are best thought as shocks that originate abroad and lead capital to flow in or out of individual countries. The latter are domestic shocks that attract foreign capital from the rest of the world. In this paper, we focus on one particular push shock—a shock to the international supply of credit. Focusing on a specific shock facilitates isolating causal effects in the empirical analysis. It also allows us to explore both the transmission mechanism and the cross-country heterogeneity in more detail from a

theoretical point of view.

We proceed in three main steps. First, we set up a theoretical model of international financial intermediation and collateralized borrowing in domestic and foreign currency. Second, we identify an international credit supply shock in the data and document its transmission and relative importance. Third, we study the differential incidence of this shock across countries considering country characteristics that affect its transmission in the model.

Both house prices and the exchange rate can have an amplification effect, by inflating the value of collateral and expanding the borrowing capacity of the economy. These channels of amplification may be more relevant depending on the characteristics of the credit market. We focus on the maximum loan-to-value ratio and the share of foreign currency liabilities over total liabilities. We assume that the source of collateral is residential housing, and that borrowing can be denominated in either foreign or domestic currency. We take both the LTV and the share of foreign currency denominated liabilities as given and study the implications of varying them exogenously across countries. Housing is usually the largest asset class in households portfolios and it is used as collateral for both mortgage and commercial borrowing. The US dollar remains the dominant currency in the international financial system with relatively constant portfolio shares over time.

The model we use has two main blocks (regions). One block is small, but financially integrated with the rest of the world. In this economy, households are relatively impatient and subject to a standard borrowing constraint like in (Kiyotaki and Moore, 1997). The other block is large and is the source of the global supply of credit. Households of the foreign economy own international financial intermediaries that operate globally and channel funds from savers to borrowers. These intermediaries are subject to an exogenous capital requirement as in Brunnermeier and Sannikov (2014) and He and Krishnamurthy (2013). A change in leverage of international financial intermediaries leads to an increase in the international supply of credit, similar to the one we will consider in our empirical analysis.

In the model, the shift in the international credit supply leads to a consumption boom, an appreciation of the real exchange rate, and house prices inflation (while the expected return on these assets falls), in line with the unconditional evidence we

document in Figure 1. If the collateral constraint is binding, house prices always expand households' borrowing capacity in the model. Similarly, when credit is denominated in foreign currency and the constraint is binding, a real exchange rate appreciation boosts the borrowing capacity of the economy in foreign currency. Movements in the real exchange rate, however, affect the economy also through two other channels. In particular, the value of the domestic endowment increases, and the purchasing power of any new debt denominated in foreign currency declines. While the collateral effect of a house price increase is always expansionary, the net effect of the appreciation is an empirical/quantitative matter.

Overall, the predictions of the model provide a solid theoretical foundation for our empirical analysis, even though we make a number of simplifying assumptions to keep the framework tractable and highlight the key mechanisms at work. The model not only underpins the identification of our international credit supply shock in the data, but also highlights specific mechanisms of transmission that are useful to interpret the evidence we report. The model also helps us select country characteristics that may be associated with a different sensitivity to such a shock, illustrating that the house price and exchange rate collateral effects can be stronger the higher the LTV ratio and the share of foreign currency debt.

Next, we investigate empirically the transmission and the relative importance of our international credit supply shock, as well as the cross-country differences in its impact. We do so by specifying an unbalanced Panel Vector Autoregression model (PVAR) for 50 countries estimated with quarterly data from 1985:Q1 to 2012:Q4.

Based on the insights from the theoretical model that we develop, we augment the PVAR model with the leverage of US Broker-Dealers, and then focus on a shock to this variable. While regulation and financial innovation determine it in the longer-term (Boz and Mendoza, 2014), over the business cycle several factors, such as monetary policy, the state of the cycle, and risk appetite can affect the leverage constraint (Rey, 2013, 2016, Forbes et al., 2016). We focus on the cyclical changes and do not take a stand on the ultimate cause of these shifts. Instead, we investigate their consequences for the international supply of credit and the transmission to small open economies.

The PVAR analysis shows that our international credit supply shock triggers a sharp and persistent increase in cross-border claims, house prices and consumption. The real

exchange rate appreciates and the current account deteriorates. After about five years, these dynamics revert with some overshooting in line with the event study in Figure 1 and the transmission in the model. Our international credit supply shock is also an important source of business cycle variation, accounting for variance share of most variables between 10 and 20 percent depending on the particular model specification.

In the last step of the analysis, we study the sensitivity of the transmission to country characteristics. The individual country estimates reveal a significant degree of heterogeneity. Consistent with the predictions of the model, the impact of the shock is stronger in economies with a larger share of liabilities denominated in foreign currency and a higher loan-to-value ratio. In the model, both the tightness of the LTV limit and the share of domestic currency debt can potentially affect the impact of the international credit supply shock that we identify in the data.

Our paper relates to three strands of literature. A first set of contributions explore how US monetary or regulatory policy stance, innovations in the financial system, and risk taking behavior can affect leverage of international financial intermediaries and the global financial cycle, both from an empirical (Rey, 2013, 2016, Forbes et al., 2016) and theoretical (Bruno and Shin, 2015, Boz and Mendoza, 2014) perspective. We take these ideas one step further and investigate, both empirically and theoretically, possible mechanisms of transmission to macroeconomic variables and asset prices in individual countries. We study the next chain in the transmission of such shocks, that is, from the leverage of US Broker-Dealers to macroeconomic dynamics and asset prices in economies at the receiving end of capital inflows, also exploring the cross-country distribution of these effects.

The second strand of the literature we relate to consists of papers that study the role of international capital flows in fueling the US housing boom and subsequent crash—see, among others, Justiniano et al. (2015), and Favilukis et al. (2017).<sup>3</sup> In this paper, we explore the role of house prices and exchange rates for the transmission of capital flow shocks emanating at the center of the international financial system and potentially affecting the periphery.

Finally, this paper is also related to the literature on the sensitivity of consumption

---

<sup>3</sup>Aizenman and Jinjark (2009) investigate empirically the impact of shocks to house prices for the current account. See Gete (2009) and Ferrero (2015) for models that rationalize this direction of causality.

to house price and credit shocks. [Berger et al. \(2015\)](#) use US micro data to quantify the elasticity of consumption to changes in housing wealth. [Kaplan et al. \(2016\)](#) show that this elasticity depends on the source of the shock moving house prices. [Calza et al. \(2013\)](#) study how this elasticity depends on the mortgage market structure in a few advanced economies. We investigate this elasticity in an open-economy setting, in a large cross section of advanced and emerging economies, focusing on how it is affected by the share of foreign currency debt and the maximum LTV ratio. [Almeida et al. \(2006\)](#) document empirically how housing prices and mortgage demand respond more to income shocks in countries where households can achieve higher LTV ratios, consistent with the earlier evidence of [Jappelli and Pagano \(1989\)](#). Our theoretical and empirical analysis takes a general equilibrium approach. Finally, [Mian et al. \(2016\)](#) document a cross-country association between household debt and consumption growth. We condition our analysis on a particular source of exogenous variation in consumption—an international credit supply shock—and uncover a relation between the share of foreign currency borrowing and the maximum level of the LTV and the consumption sensitivity to such a shock for the largest panel of countries studied to date for which quarterly data on house prices are available. The estimated implied elasticity is quantitatively sizable and estimated precisely.

The rest of the paper is organized as follows. [Section 2](#) sets up the model that we use to illustrate the nature of the shock and support the VAR identification assumptions. [Section 3](#) discusses the transmission mechanism. [Section 4](#) presents the Panel VAR model and reports the response of the typical economy in our cross section to the identified international credit supply shock. [Section 5](#) investigates the cross-country sensitivity to LTV levels and the share of foreign currency debt. Finally, [Section 7](#) concludes. The paper’s appendix contains details of the event study described above, the definition and the sources of all data used in the paper. A supplement (not for publication) contains all model derivations, additional empirical results and robustness checks on the PVAR analysis.

## 2 A Model of International Borrowing and Lending

This section presents a stylized model of international financial intermediation and collateralized borrowing. The model helps us to identify an international credit supply shock in the data, to interpret its transmission, and the sensitivity of its effect to country characteristics.

The world economy lasts for two periods and consists of two blocks (countries), Home (H) and Foreign (F), of size  $n \in (0, 1)$  and  $1 - n$ , respectively. In both periods, the representative Home and Foreign household receives a country-specific endowment of non-durable goods, and consumes a bundle of the two tradable goods as well as non-tradable housing services, which are proportional to the stock of housing. For simplicity, we abstract from construction and assume that housing is in fixed supply, like land. The two blocks differ in the degree of patience of their representative household. The Home household is relatively impatient and borrows to purchase housing services subject to a collateral constraint. The Foreign household saves via deposits and equity holdings in a global financial intermediary that channels funds to the borrowers and is subject to a leverage constraint (or, equivalently, a capital requirement).

### 2.1 Goods Markets

The structure of the goods markets is standard. The representative Home household consumes a Cobb-Douglas basket of Home and Foreign goods:

$$c = \frac{c_H^\alpha c_F^{1-\alpha}}{\alpha^\alpha (1-\alpha)^{1-\alpha}}, \quad (1)$$

where  $\alpha \in (0, 1)$  is the steady state share of consumption on Home goods. Following [Sutherland \(2005\)](#), we assume that the weight of imported goods in the Home consumption basket is a function of the relative size of the foreign economy ( $1 - n$ ):

$$\alpha \equiv 1 - (1 - n)\lambda,$$

where  $\lambda \in (0, 1)$  represents the degree of openness, equal for both countries. This assumption implies  $\alpha \in (n, 1]$  and generates home bias in consumption.<sup>4</sup>

Expenditure minimization implies that the demand for Home and Foreign goods by Home households is:

$$c_H = \alpha \left( \frac{P_H}{P} \right)^{-1} c \quad \text{and} \quad c_F = (1 - \alpha) \left( \frac{P_F}{P} \right)^{-1} c, \quad (2)$$

where  $P_H$  and  $P_F$  are the Home currency prices of the Home and Foreign goods, respectively, and  $P$  is the overall price level. These price indexes are related to each other according to:

$$P = P_H^\alpha P_F^{1-\alpha}. \quad (3)$$

The consumption bundle of the representative household in the Foreign block corresponds to (1), with  $\alpha^* \equiv n\lambda$  representing the Foreign consumption share of imported goods. The demand for Home and Foreign goods by the Foreign household are identical to (2), with the only difference that an asterisk denotes Foreign variables.

## 2.2 Exchange Rates and Relative Prices

The nominal exchange rate  $\mathcal{E}$  is defined as the number of units of Home currency required to buy one unit of Foreign currency, so that an increase of the nominal exchange rate corresponds to a depreciation of the Home currency. We assume that the law of one price (LOOP) holds for each good:

$$P_H = \mathcal{E}P_H^* \quad \text{and} \quad P_F = \mathcal{E}P_F^*, \quad (4)$$

where  $P_H^*$  and  $P_F^*$  are the Foreign currency prices of the Home and Foreign goods, respectively.

The terms of trade  $\tau$  for the Home country represents the price of imports relative

---

<sup>4</sup>The size of home bias decreases with the degree of openness and disappears when  $\lambda = 1$ . In the limit for  $n \rightarrow 0$ , the Home block becomes a small open economy. We will study this special case in details below.

to the price of exports, where both prices are expressed in terms of the Home currency:

$$\tau = \frac{\mathcal{E}P_F^*}{P_H}. \quad (5)$$

An increase in the terms of trade corresponds to a rise in the price of imports relative to exports for the Home consumer in Home currency, so that Foreign imports become relatively more expensive. In this sense, an increase in  $\tau$  represents a deterioration of the terms of trade for the Home country (i.e. a depreciation). All relative prices are a function of the terms of trade:

$$p_H = \tau^{\alpha-1} \quad \text{and} \quad p_F = \tau^\alpha, \quad (6)$$

where  $p_k \equiv P_k/P$ , for  $k = \{H, F\}$ . The same conditions hold for the Foreign country.

The real exchange rate  $s$  is the price of Foreign consumption in terms of Home consumption:

$$s \equiv \frac{\mathcal{E}P^*}{P}. \quad (7)$$

A higher  $s$  corresponds to an increase in the price of the Foreign consumption basket relative to the Home consumption basket in terms of the Home currency, and thus to a depreciation of the real exchange rate. In spite of the LOOP, purchasing power parity does not hold because of home bias, that is, the real exchange rate is generally different from one. However, the (log) real exchange rate is proportional to the (log) terms of trade:

$$s \equiv \frac{\mathcal{E}P^*}{P} = \frac{\mathcal{E}P_F^*}{P_H} \times \frac{p_H}{p_F^*} = \tau^{\alpha-\alpha^*}. \quad (8)$$

Therefore, we can characterize the equilibrium indifferently with respect to a single relative price.

## 2.3 Home Households

A continuum of measure  $n \in [0, 1]$  of households populate the Home economy. All households are identical and relatively impatient. We denote by  $c_1$  and  $c_2$  their consumption in the two periods. In addition, in period 1, households decide once and for all the amount of housing services to purchase, which we assume to be proportional to

the housing stock  $h_1$ . Lifetime utility therefore is:

$$\mathbb{U} = u(c_1) + \beta u(c_2) + v(h_1), \quad (9)$$

where  $\beta \in (0, 1)$  is the individual discount factor. Preferences are risk-neutral with respect to consumption (i.e.  $u'(\cdot) = \bar{c} > 0$ ), and are increasing and weakly concave with respect to housing (i.e.  $v'(\cdot) > 0$  and  $v''(\cdot) \leq 0$ ).

Households are endowed with  $y$  units of Home goods in each period and  $h_0$  initial units of housing, and can obtain credit denominated in either Home ( $b$ ) or Foreign ( $f$ ) currency. Thus, the budget constraint in period 1 is:

$$c_1 + qh_1 - b - s_1f = p_{H1}y + qh_0, \quad (10)$$

where  $q$  is the relative price of houses in terms of the consumption good, and we have assumed that the household starts with no credit to repay. In the second period, the household repays the debt contracted in the first period plus a gross interest rate, so that the budget constraint is:

$$c_2 = p_{H2}y - R^b b - s_2 R f, \quad (11)$$

where  $R^b$  and  $R$  are the gross interest rates on credit denominated in Home and Foreign currency, respectively.

While in practice households (and banks) choose the currency denomination of their credit portfolio, in this paper, we abstract from this decision and treat the share of foreign currency denominated credit as given.<sup>5</sup> In particular, we will characterize the equilibrium in terms of the ratio between credit in Home and Foreign currency:

$$\eta \equiv \frac{b}{s_1 f}, \quad (12)$$

so that  $1/(1 + \eta)$  represents the share of Foreign currency liabilities in total credit from the perspective of the Home country, which can be measured in the data. If  $\eta = 0$ , the model corresponds to the limiting case in which all credit is denominated in Foreign

---

<sup>5</sup>In Figure S.1 of the supplement we show that, at the country level, the share of foreign currency liabilities in total liabilities is rather constant over time.

currency. As  $f$  decreases,  $\eta$  increases, and in the limit the share of Foreign currency debt goes to zero.

Following [Kiyotaki and Moore \(1997\)](#), a collateral constraint limits total debt to a fraction  $\theta \in [0, 1]$  of the value of housing purchased in period 1:

$$b + s_1 f \leq \theta q h_1. \quad (13)$$

The parameter  $\theta$  represents a limit that lenders impose on borrowers to mitigate issues related to asymmetric information. In practice, however,  $\theta$  is also affected by policy as in many national housing finance systems regulation mandates the maximum loan-to-value (LTV) ratio that lenders can offer. Because borrowing is denominated in foreign-currency, both house prices and the exchange rate enter this constraint. Thus, equation (13) combines the typical specifications adopted in the housing and the open economy macroeconomics literatures.

The Home household maximizes (9) subject to (10), (11), and (13). Let  $\mu \bar{c}$  be the Lagrange multiplier on the borrowing constraint, normalized by the marginal utility of consumption ( $\bar{c}$ ). The first order conditions for the optimal demand of credit in period 1 in Home and Foreign currency are, respectively:

$$1 - \mu = \beta R^b \quad \text{and} \quad 1 - \mu = \beta R \frac{s_2}{s_1}, \quad (14)$$

with  $\mu > 0$  when  $b + s_1 f = \theta q h_1$ . The two expressions in (14) are the consumption Euler equations under risk neutrality. Under these assumptions, when binding, a tighter borrowing constraint (i.e., a higher  $\mu$ ) reduces the cost of forgoing consumption today (or increases the benefits of saving today). No arbitrage requires Home households to be indifferent between credit denominated in Home and Foreign currencies and yields:

$$R^b = R \frac{s_2}{s_1}, \quad (15)$$

which corresponds to the uncovered interest rate parity condition in real terms.<sup>6</sup>

---

<sup>6</sup>It is well known that the uncovered interest rate parity condition fails in the data, at least in the short-run. For instance, by using loan-level data for Turkey, [Baskaya et al. \(2017\)](#) document that persistent differentials in domestic and foreign borrowing costs vary with the global financial cycle. [Salomao and Varela \(2017\)](#) analyze the implications of UIP failure for the currency composition of

The Euler equation for the choice of housing services is:

$$(1 - \theta\mu)q = \frac{v'(h_1)}{\bar{c}}, \quad (16)$$

and shows that house prices are higher (i) the higher the maximum LTV ratio  $\theta$  (ii) and the tighter the borrowing constraint  $\mu$ .

Note here that, all else equal, both the level of the LTV and the tightness of the borrowing constraint increase housing demand. A higher LTV directly allows for more borrowing in equation (14) and hence more consumption, including more housing services. Similarly, a tighter borrowing constraint (a higher value of the multiplier  $\mu$ ) increases house prices via higher demand for scarce collateral.<sup>7</sup> However, when the collateral constraint is not binding ( $\mu = 0$ ), housing demand is constant and house prices are equal to their fundamental value, that is the marginal utility of housing in units of marginal utility of consumption. In this case, the housing market is insulated from exogenous shocks that affect other parts of the economy.

The unconditional evidence reported in the previous section suggests that both the real exchange rate and house prices increase during periods of capital inflows. In our model, both asset prices can amplify the effects of an international credit supply shock, but with different mechanisms. An increase in house prices boosts the (Home currency) value of the collateral and expands the households' borrowing capacity, thus supporting consumption of housing and non housing only when the collateral constraint binds. This “collateral house price effect” is evident from equation (13), and the mechanism corresponds to the standard amplification channel associated with house prices in the closed economy literature (e.g. [Kiyotaki and Moore, 1997](#)). Note here that this effect is stronger the higher is the LTV. When the collateral constraint is not binding, however, the feedback from house prices to the rest of the economy disappears because of our simplifying assumptions on housing preferences and technology.

In contrast, the exchange rate can amplify the effects of an international credit supply shock independently of whether the collateral constraint is binding or not. When total borrowing is constrained, equation (13) shows that an exchange rate appreciation

---

credit. In the model, we abstract from frictions that may lead the UIP to fail.

<sup>7</sup>This effect is particularly stark in our model because of the assumptions of risk neutrality and fixed housing supply.

expands the borrowing capacity of the economy like house prices do, but in Foreign as opposed to Home currency—an effect that we label “collateral exchange rate effect.” Note here that this effect is stronger the higher the share of foreign currency liability. As we can see from the budget constraint (10), an appreciation also boosts the purchasing power of the Home endowment, but it reduces that of any given amount of foreign currency debt regardless of whether the constraint binds or not.<sup>8</sup> We call these two latter effects “endowment valuation effect”, and “debt valuation effect”, respectively. Note here again that the debt valuation effect is also increasing in the share of foreign currency liabilities like the collateral exchange rate effect.

Both the debt and collateral exchange rate effects become less severe as the share of foreign currency declines (i.e.,  $\eta$  gets bigger). We can see the dependency of the debt valuation effect on the share of foreign currency credit by rewriting the budget constraint in terms of  $\eta$  as:

$$c_1 + qh_1 - (1 + \eta)s_1f = p_{H1}y + qh_0.$$

Similarly, rewriting the borrowing constraint at equality as a function of  $\eta$ , we can see that the collateral exchange rate effect is also declining in  $\eta$ :

$$(1 + \eta)s_1f = \theta qh_1.$$

In both cases, a higher value of  $\eta$  dampens the effect of an appreciation of the real exchange rate (a fall in  $s_1$ ) on the purchasing power of a given amount of credit in Foreign currency  $f$ .

The collateral exchange rate effect reinforces the endowment valuation effect, but could be offset by the debt valuation effect. The overall impact on the economy is a quantitative matter that depends on the total level of borrowing as well as its currency composition. But an appreciation is more likely to be expansionary in our model at higher levels of debt and higher shares of foreign currency debt, so that the borrowing constraint is more likely to bind and hence to activate the exchange rate collateral effect.

---

<sup>8</sup>In a fully dynamic setting, the latter effect would trade off the lower purchasing power of a given amount of debt contracted in the current period with the lower repayment on credit obtained in the past.

## 2.4 Foreign Households

The Foreign economy is populated by a continuum of identical households of measure  $1 - n$ . Foreign households are relatively patient and derive utility solely from consumption ( $c^*$ ). Their utility function is:

$$\mathbb{U}^* = u(c_1^*) + \beta^* u(c_2^*), \quad (17)$$

with  $\beta^* \in (\beta, 1)$ . Because of their relative patience, the borrowing constraint of the Foreign representative household never binds in equilibrium. Therefore, we abstract from Foreign purchases of housing services, as house prices in country F would be irrelevant for the equilibrium.<sup>9</sup>

Foreign households are endowed with  $y^*$  units of Foreign goods in each period, and can save via deposits ( $d$ ) or equity holdings subject to adjustments costs ( $e$ ) with financial intermediaries. The budget constraint in period 1 is:

$$c_1^* + d + e + \psi(e) = p_{F1}^* y^*, \quad (18)$$

where  $\psi(\cdot)$  (with  $\psi', \psi'' > 0$ ) is a convex cost of changing the equity position.<sup>10</sup> As in [Jermann and Quadrini \(2012\)](#), the equity adjustment cost creates a “pecking order” of liabilities whereby intermediaries always prefer to issue debt relative to equity. The budget constraint in the second period is:

$$c_2^* = p_{F2}^* y^* + R^d d + R^e e + \Pi, \quad (19)$$

where  $R^d$  and  $R^e$  are the real gross returns on deposits and equity, respectively, and  $\Pi$  stands for the profits of the global financial intermediary that the Foreign representative household owns.

The problem of the foreign representative household is to maximize (17) subject to

---

<sup>9</sup>The only difference from explicitly incorporating foreign housing decisions would be to price housing in the lending country—something our empirical evidence has little to say about. The Foreign counterpart of equation (16) with  $\mu^* = 0$  shows that we would obtain a solution for Foreign house prices of the form  $q^* = v'(h_1^*)/\bar{c}^*$ .

<sup>10</sup>For simplicity, we assume global financial intermediaries are set up in the first period, and normalize to zero initial deposits and equity.

(18) and (19). The first order conditions for the optimal choice of deposits and equities are:

$$1 = \beta^* R^d, \quad (20)$$

and

$$1 + \psi'(e) = \beta^* R^e. \quad (21)$$

Combining these two first order conditions, we obtain:

$$R^e = R^d + \frac{\psi'(e)}{\beta^*}.$$

Because of the presence of adjustment costs, the return on equity pays a premium over the return on deposits, which is increasing in the degree of convexity of the portfolio cost of adjustment function.

## 2.5 Global Financial Intermediaries

A representative financial intermediary (a global bank) operates in international credit markets and channels loans from patient Foreign lenders to impatient Home borrowers, funding its activity with a mix of equity and deposits raised in the Foreign country.<sup>11</sup>

Table 1 below summarizes the balance sheet of financial intermediaries in period 1. As discussed earlier, a given fraction  $\eta$  of their loan book is denominated in Home currency. Following Bräuning and Ivashina (2016), we assume that global financial intermediaries swap their exchange rate exposure by entering a contract with perfectly competitive specialized FX traders. These traders are endowed with a large amount of capital  $K$  and make zero profits. Using swap contracts, global banks can ensure that only the total size of the asset side of their balance sheet matters, and not its currency composition.

The profits of a generic financial intermediary at market value correspond to the total return on loans, net of the payouts to depositors and equity holders, and the

---

<sup>11</sup>Obviously, this representation of the financial system is a gross oversimplification, as we abstract from domestic financial intermediation. The benefit of our assumption is that we can isolate the role of global banks and their interaction with the frictions on the demand side of domestic credit for the transmission of global financial shocks.

**Table 1.** BALANCE SHEET OF A TYPICAL GLOBAL FINANCIAL INTERMEDIARY.

Assets		Liabilities	
Loans (Home currency):	$b/s_1$	Deposits:	$d$
Loans (Foreign currency):	$f$	Equity:	$e$

hedging costs:

$$\Pi = Rf + \frac{R^b b}{s_2} - R^d d - R^e e - \phi\left(\frac{b}{s_1}\right), \quad (22)$$

where  $\phi(\cdot)$  (with  $\phi'(\cdot), \phi''(\cdot) > 0$ ) represents the cost of swapping the total amount of credit denominated in Home currency issued by an intermediary.

Because equity is more expensive than deposits, financial intermediaries would like to lever their balance sheet as much as possible. We assume that a capital requirement limits leverage and the size of their balance sheet:

$$e \geq \chi \left( \frac{b}{s_1} + f \right), \quad (23)$$

with  $\chi \in (0, \bar{\chi})$ .<sup>12</sup>

The problem for the representative global financial intermediary is to maximize (22) subject to the leverage constraint (23) and the balance sheet constraint. Using the no arbitrage condition (15) and the definition of the share of credit denominated in Home currency (12) introduced earlier, we can rewrite the problem of the representative global bank as:

$$\max_f \Pi = (1 + \eta)Rf - R^d d - R^e e - \phi(\eta f),$$

subject to the balance sheet constraint:

$$(1 + \eta)f = d + e, \quad (24)$$

and the capital constraint:

$$e \geq \chi(1 + \eta)f.$$

<sup>12</sup>Gabaix and Maggiori (2014) obtain a similar constraint assuming that financiers can divert part of the funds intermediated through their activity.

The main theoretical experiment that we focus on in the model is a one-time change in the capital constraint  $\chi$ . We then map the results of this experiment into the identification of our international credit supply shock in the VAR analysis of the next section. For this purpose, we will focus on an equilibrium in which the capital constraint is binding. If the capital constraint were slack, financial intermediaries would become irrelevant, and a shock to  $\chi$  would have no effect on macroeconomic variables and asset prices.

After substituting for deposits from the balance sheet constraint and for equity from the binding capital constraint, intermediaries profits become:

$$\Pi = [R - \chi R^e - (1 - \chi)R^d] (1 + \eta)f - \phi(\eta f). \quad (25)$$

The first order condition for the optimal choice of lending is:

$$R = \chi R^e + (1 - \chi)R^d + \frac{\eta}{1 + \eta} \phi'(\eta f). \quad (26)$$

The lending rate is a weighted average of the funding costs, plus the cost of swapping the position denominated in Home currency. The capital constraint  $\chi$  represents the weight on the return on equity: a tighter leverage constraint (a higher  $\chi$ ) implies a higher cost of equity, which is passed on to borrowers in the form of a higher loan rate. The last term on the right-hand side is the cost of swapping Home currency lending: for given  $f$ , the loan rate is increasing in the share of credit issued in Home currency. Similarly, for given  $\eta$ , the loan rate is increasing in the amount of credit issued in Foreign currency because a larger balance sheet with a fixed share of Home currency credit corresponds to a larger amount of loans to swap.

## 2.6 Equilibrium

We characterize the equilibrium in terms of the quantity of credit denominated in Foreign currency  $f$ , for a given share of credit denominated in Home currency  $\eta$ , which we treat as a parameter. In equilibrium, the demand for housing within each country must equal the available supply, which is fixed and, without loss of generality, normalized to one ( $h_0 = h_1 = 1$ ). A competitive equilibrium for this economy is a collection of

quantities and prices such that:

1. Domestic households maximize their utility subject to their budget and collateral constraints;
2. Foreign households maximize their utility subject to their budget constraints;
3. Financial intermediaries maximize their profits subject to their balance sheet and leverage constraint;
4. Goods market clear in every period.

The full list of equations that characterize the equilibrium of our model is reported in Appendix. Here we discuss the special case of a small open economy as we assume in our empirical analysis in section 4.

### **3 The Small Open Economy Case: An Example**

In our empirical analysis, we will focus on the transmission of an international credit supply shock to individual countries. The key identifying assumption will be that each country in our sample is too small to influence the global supply of credit. This case can be analyzed in the model by taking the limit for  $n$  that goes to zero (a small open economy) and using our assumption about the degree of home bias that links country size, consumption shares, and degree of openness. This small open economy assumption implies that Home demand does not affect the equilibrium in the market for Foreign goods. In this case, we can solve for the real exchange as a function of the quantity of credit and the interest rate. The credit market then determines the entire equilibrium of the model.

### 3.1 The Exchange Rate and the Credit Market

Credit demand interacts with the goods market through the real exchange rate, which in period 1 and 2 is given by:<sup>13</sup>

$$s_1 = \left[ \frac{\lambda y}{\lambda y^* + (1 - \lambda)(1 + \eta)f} \right]^{1-\lambda}, \quad (27)$$

$$s_2 = \left[ \frac{\lambda y}{\lambda y^* - (1 - \lambda)R(1 + \eta)f} \right]^{1-\lambda}. \quad (28)$$

Intuitively, higher borrowing in period 1 implies higher Home demand, and hence an appreciation of the terms of trade (and consequently of the real exchange rate). However, higher borrowing in period 1 also means, higher interest repayments in period 2, and hence lower demand and a depreciation in period 2.

#### Credit supply

The credit supply schedule is upward-sloping in the  $\{f, R\}$  space:

$$R = \frac{1 + \chi\psi'[\chi(1 + \eta)f]}{\beta^*} + \frac{\eta\phi'(\eta f)}{1 + \eta}, \quad (29)$$

A larger balance sheet requires more equity to satisfy the capital constraint. Since equity is costly to raise, global financial intermediaries charge a higher lending rate to borrowers. In addition, as mentioned earlier, for a fixed share of Home currency credit in total credit, a larger balance sheet implies a higher swapping cost, which financial intermediaries pass on to borrowers. These two effects make credit supply increasing in the level of the interest rate.

The shock that we study originates from the balance sheet of global banks and is transmitted to individual countries through the international credit market. As equation (29) shows, an increase in the leverage of financial intermediaries (a reduction of the capital requirement parameter  $\chi$ ) shifts down the credit supply schedule. At any level of credit, the interest rate offered on loans issued to the Home country must fall. This mechanism is what underpins our identification assumptions in the VAR of section

---

<sup>13</sup>The derivations of these equilibrium relations are reported in a supplement available upon request.

4.

## Credit Demand

The credit demand schedule differs depending on whether the collateral constraint binds or not. In particular, credit demand is a piecewise function with a kink at the level of credit where the borrowing constraint becomes binding:

$$R = \begin{cases} \frac{1}{\beta} \frac{s_1}{s_2} & \text{if } (1 + \eta)s_1 f < \theta q \\ \frac{1}{\beta} \frac{s_1}{s_2} \left[ \frac{\kappa}{(1 + \eta)s_1 f} - \frac{1 - \theta}{\theta} \right] & \text{if } (1 + \eta)s_1 f = \theta q. \end{cases} \quad (30)$$

If the collateral constraint does not bind, the slope of the credit demand schedule is negative. In this region, the LTV level is irrelevant for the equilibrium. If the constraint binds, credit demand is downward-sloping for a sufficiently high level of the LTV ratio.<sup>14</sup>

## 3.2 Equilibrium

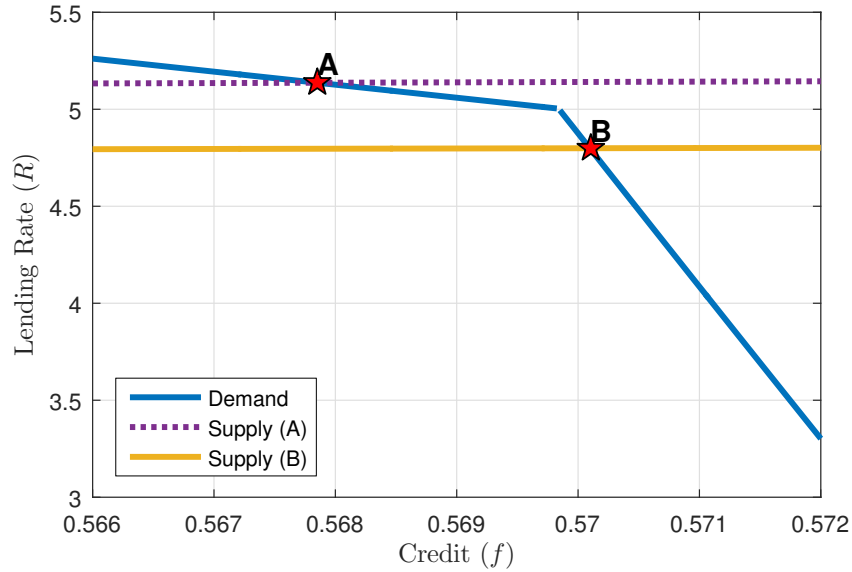
Figure 3 plots the credit market equilibrium in the space  $\{f, R\}$  for a reasonable choice of the parameters values. Starting with credit demand, which results from combining (27), (28), and (30), we normalize the endowment in both countries to  $y = y^* = 1$  and fix the marginal utility of housing in units of marginal utility of consumption to  $\kappa = 0.85$ . We set a high value for  $\theta$ , equal to 0.9, consistent with the observed (median) maximum LTV limit in our sample of countries, and  $\eta = 0.43$  to match the median share of foreign currency liabilities from BIS data. We pick a value for the openness parameter ( $\lambda = 0.79$ ) slightly larger than in Gali and Monacelli (2005) but within the range discussed in the literature. Finally, we set the domestic discount factor to  $\beta = 0.9$  to yield a lending spread of about 100 basis points, whether the borrowing constraint is binding or not.

Focus next on the credit supply (equation 29). The parameters that pin down its

---

<sup>14</sup>See the supplement for the formal derivations of the slope of the credit demand schedule in the two regions.

**Figure 3.** INTERNATIONAL CREDIT MARKET EQUILIBRIUM.

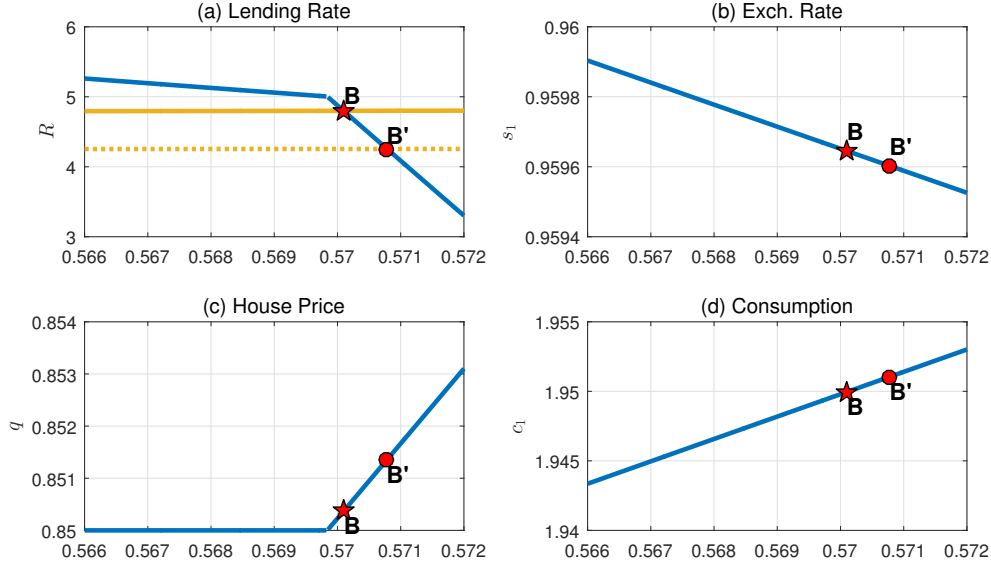


NOTE. Point A: Unconstrained equilibrium. Point B: Constrained Equilibrium. Credit volume on the horizontal axis. The net (annualized) interest rate in on the vertical axis.

shape are the capital requirement, the discount factor of country F, and the adjustment cost parameters. We choose a capital requirement of 10% ( $\chi = 0.1$ ) to target a leverage ratio of 10—a value that is close to the average leverage of US commercial banks in the data. We set  $\beta^* = 0.99$  to obtain  $R^d = 4.1\%$  in annualized terms. We assume that the adjustment costs for equity holdings and the hedging cost are both quadratic and set their parameters residually. Given the rest of the calibration, their values determine whether the borrowing constraint is binding or not, and the premium that bank equity pays over deposits.

Figure 3 displays the two types of credit market equilibrium that can arise in the model, depending on whether the constraint binds or not. For example, for a given cost of hedging, if the equity adjustment cost parameter is relatively high ( $\zeta = 0.03$ ), financial intermediaries pay a large premium over the return on deposits (about ten and a half percentage points). In this case, the equilibrium is in the unconstrained region (point A), with a relatively high interest rate on loans of 5.2% and a low level of credit. When the equity adjustment cost is relatively low ( $\zeta = 0.02$ ), the equity

**Figure 4.** INTERNATIONAL CREDIT SUPPLY SHOCK WITH BINDING BORROWING CONSTRAINT.



NOTE. Change in  $\chi$  from 0.1 to 0.02 (with leverage going from 10 to 50). Initial equilibrium: constraint is binding like in Point  $B$  in Figure 3. New equilibrium: Point  $B'$ . Credit volume on the horizontal axis.

premium is smaller (approximately seven percentage points), credit is abundant, and the interest rate on loans is lower at about 4.9%. In this case, given the LTV value, demand meets supply in the constrained region (point  $B$ ).

### 3.3 The Transmission of a Leverage Shock

Figure 4 illustrates graphically the change in the credit market equilibrium (top-left panel), and the response of the real exchange rate (top-right panel), house prices (bottom-left panel), and consumption (bottom-right panel), to a reduction of  $\chi$  from 0.1 to 0.02 in the region where the collateral constraint is binding.

We start from the same constrained equilibrium of Figure 3 (point  $B$ ) with low equity premium. The reduction in capital requirements of global banks increases the international supply of credit. The credit supply schedule shifts downward, and the new credit market equilibrium occurs in point  $B'$  (top-left panel of Figure 4), with higher credit and a lower interest rate. The higher availability of credit pushes up

house prices (bottom-left panel). As demand rises in the Home country, the real exchange rate also appreciates (top-right panel) and consumption increases (bottom-right panel). While Figure 4 traces the impact of the shock for the particular set of parameter values discussed above, in appendix we show that the sign of these derivatives is preserved as long as the model solution is approximated around a steady state in which the constraint is binding. A similar adjustment would also occur if the economy experienced the same shock starting from point A in Figure 3. The main difference is that, with a non-binding collateral constraint, house prices in the Home country would not be responsive to the increase supply of credit.<sup>15</sup>

## 4 An International Credit Supply Shock in the Data

In this section we identify an international credit supply shock empirically and discuss its impact on selected macroeconomic variables and asset prices of the receiving economies. We use a panel-vector autoregressive model (PVAR) that allows us to investigate both the behavior of the typical economy in response to the shock and the cross-countries differences in this transmission. As we shall see, most empirical findings are consistent with the predictions of our model.

### 4.1 A PVAR Model

The PVAR model includes the leverage ratio of US Broker-Dealers to identify an international credit supply shock, and a small set of domestic variables that have a direct counterpart in the theoretical model. The set of domestic variables includes cross-border bank claims on financial and non-financial sector, real private consumption, real house prices, the real exchange rate vis-a-vis the US Dollar, and the current account balance as a share of country GDP. In the model, the private sector corresponds to households borrowing against housing collateral. For consistency, in the data, we do not distinguish between credit towards households and firms, and we focus on house prices as the key domestic asset price for the transmission of the exogenous shock. We

---

<sup>15</sup>Starting from point A, with a large enough shock, the economy could also move from the unconstrained to the constrained equilibrium. The adjustment in this case would be identical to that depicted in Figure 4.

do not include a price measure corresponding to the credit variable selected because quarterly time series for interest rate on loans are not available for our large country panel. Nonetheless, below we use the model to link the response of house prices and the real exchange rate, which are observables, to the interest rate on loans.

The specification for each country  $i$  is:

$$x_{it} = a_i + b_i t + c_i t^2 + F_{1i} x_{i,t-1} + u_{it}, \quad (31)$$

where  $x_{it}$  is the vector of endogenous variables,  $a_i$  is a vector of constants,  $t$  and  $t^2$  are vectors of deterministic trends,  $F_{1i}$  is a matrix of coefficients, and  $u_{it}$  is a vector of reduced form residuals with variance-covariance matrix  $\Sigma_{iu}$ . All variables considered enter in log-levels, except for the current account, which is expressed in percentage of country GDP.<sup>16</sup> The empirical model is the same for all countries to avoid introducing differences in country responses due to different specifications, and because it would be difficult to find a data-congruent specification for all 50 countries in our sample. In particular, somewhat arbitrarily, but mindful of the relatively short sample period for some of the emerging economies, we include one lag of each variable in every system. The full sample period is 1985:Q1-2012:Q4, but some country models are estimated with a later starting date, depending on data availability.

We estimate the model using the mean group estimator of [Pesaran and Smith \(1995\)](#) and [Pesaran et al. \(1996\)](#), as pooled estimators are not consistent in dynamic panel data model with slope coefficients varying across countries. In the estimation, we drop all countries which have less than 40 observations or have unstable dynamics (i.e., with eigenvalues larger than 1). This selection leaves us with 51 out of the 57 countries initially in our event study.<sup>17</sup>

---

<sup>16</sup>The country VAR system can be consistently estimated in levels with OLS even if it contains some unit roots (see [Sims et al., 1990](#)). See the supplement for robustness to using Local Projections as in [Jorda \(2005\)](#).

<sup>17</sup>Specifically, we drop from our original sample Brazil, Colombia, Greece, Indonesia because of unstable dynamics, and Morocco and Serbia because of the small number of observations.

## 4.2 Identification

We want to identify a shock to the international supply of credit as in the model presented in previous section. The model shows that changes in leverage of international financial intermediaries lead to an international credit supply expansion. In the PVAR model, we use innovations to US Broker-Dealers' leverage as a source of exogenous variation in the international supply of credit, and cross-border claims of BIS reporting banks as our measure of international credit.<sup>18</sup> Leverage of US Broker-Dealers can be readily measured from US Flow of Funds data. These institutions are also a good proxy for the global financial intermediaries that we considered in the theoretical analysis.

Consistent with the small open economy assumption in our model, our key assumption is that leverage of US Broker-Dealers is not contemporaneously affected by conditions in individual countries outside the United States. Since the leverage of US Broker-Dealers is endogenous to the US business cycle, we do not include the US in the sample, leaving us with 50 countries. In the estimation of the country-specific VARs, we allow for lagged feedback of the domestic economy into the leverage equation. Proceeding in this way does not compromise either the consistency or the efficiency of estimates obtained, given that we do not use country-specific standard errors to construct the variance of the mean group estimator. For robustness, however, we compute also a restricted specification of the VAR in which we eliminate this lagged feedback, and the results are actually stronger.

In practice, we obtain the impulse responses of all other variables in the country VAR systems to an international credit supply shock from the Cholesky factorization of the variance-covariance matrix of the estimated reduced-form residuals, with leverage ordered first in the system.<sup>19</sup>

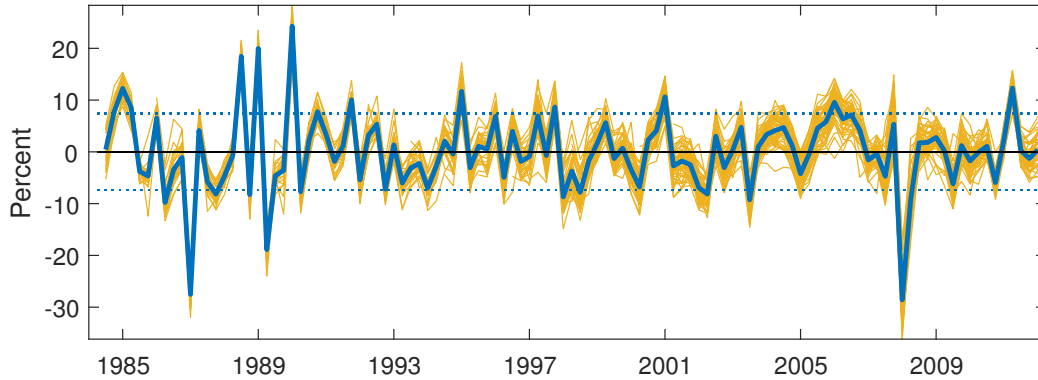
Figure 5 reports the orthogonalized leverage innovations for each of the country-specific models (light solid lines) together with their cross-country average (dark solid line) and standard deviation (straight dotted lines). The figure shows that, despite

---

<sup>18</sup>Bruno and Shin (2015) also show that changes in the leverage of US Broker-Dealers have a well-defined theoretical and empirical linkage with changes in BIS cross-border claims.

<sup>19</sup>Note here that the order of the other endogenous variables in the VAR system does not matter for the transmission of the leverage shock.

**Figure 5.** ESTIMATED INTERNATIONAL CREDIT SUPPLY SHOCK.



NOTE. The light solid lines are the orthogonalized leverage innovations for each of the country-specific models. The dark solid line is the cross-country average of the country-specific leverage innovations. The dotted lines are the average of the one-standard deviation bands, equal to 7.5 percent per quarter.

estimating the system in levels, the shocks are stationary and well-behaved.<sup>20</sup> Note here that shocks differ slightly across countries because of the lagged feedback from the rest of the system to leverage equation and the fact that models are estimated over different sample periods (depending on data availability).

While leverage of the international financial intermediaries is exogenous in our model, in the data various factors can affect the leverage of US Broker-Dealers. Long-term determinants include financial regulations and innovation (e.g., [Boz and Mendoza \(2014\)](#)), liquidity conditions and systemic risk, as well as the state of the business cycle (see, for example, [Bruno and Shin, 2015](#), [Rey, 2013](#), [Bekaert et al., 2013](#)).

Table 2 reports regressions of the average orthogonalized residual in Figure 5 on these underlying, more structural determinants of US Broker-Dealers' leverage. For monetary policy, we consider both the raw change in the Federal Funds Rate ( $\Delta FFR_t$ ), capturing the systematic component of monetary policy, as well as its surprise component ( $\epsilon_t^{MP}$ ) measured with [Romer and Romer \(2004\)](#) monetary policy shocks. We also include the slope of the yield curve ( $R_t^L - R_t$ ), which contains information about the state of the US business cycle and term risk premia. Finally, we consider the VIX

---

<sup>20</sup>A simple test fails to reject the null hypothesis that there is no serial correlation in the estimated shocks.

**Table 2.** BROKERS-DEALERS' LEVERAGE INNOVATIONS AND THEIR UNDERLYING DETERMINANTS.

$x_t$	(1)	(2)	(3)	(4)	(5)
$\Delta FFR_t$	-2.477** [-2.364]				-2.613** [-2.536]
$\epsilon^{MP}$		-0.0497 [-0.650]			
$R_t^L - R_t$			-0.900 [-1.642]		
$VIX_t$				-0.00182** [-2.057]	-0.00195** [-2.252]
Obs.	111	91	111	111	111
Adj. $R^2$	0.049	0.005	0.024	0.037	0.091

NOTE. The Table reports a regression of the leverage innovations in Figure 5 (average across countries) on their possible determinants:  $\epsilon_t^{LEV} = \beta x_t$ .  $\Delta FFR_t$  is the first difference of the real (ex-post) federal fund rate;  $\epsilon^{MP}$  is Romer and Romer (2004) monetary policy shock;  $R_t^L - R_t$  is the slope of the US yield curve;  $VIX_t$  is the VIX index. The regressions also include a constant and world GDP (not reported).

volatility index ( $VIX_t$ ) as a raw measure of systemic risk.

Consistent with the available evidence, leverage tends to increase when US policy rates and volatility fall, and to a lesser extent, when the term premium declines. In fact, the term premium is only marginally significant statistically, and drops out when we enter these variables jointly in the regression. Note, however, that the adjusted R-squared of the regressions is quite low, approaching 10 percent only when the VIX index and Fed Funds Rate changes enter together. This finding suggests that these two variables would be relatively weak instruments.<sup>21</sup>

For our purposes we do not need to take a stand on the underlying structural sources of cyclical change in the leverage data. As long as country-specific, domestic pull

<sup>21</sup>Cesa-Bianchi et al. (2015) use these variables as instruments for cross-border claims in a similar set up, along with US Broker-Dealers' leverage, applying the external instrument approach of Mertens and Ravn (2013) and Stock and Watson (2012). Their optimal instrument selection procedure chooses leverage as preferred instrument for most countries, but the F-statistic is often below the threshold value to avoid weak instruments problems. The estimation results of the instrumental variables approach are very similar to those obtained in this paper.

factors do not affect leverage of US Broker-Dealers, we can treat changes in leverage as an exogenous push shock to capital flows that increases the international credit supply like in our model.

One concern to our identification strategy, however, may be that common shocks to many small open economies may affect leverage. When we control for world GDP and world equity prices (see the supplement), the results are largely unchanged.

### 4.3 Response of a Typical Small Open Economy

Figure 6 reports the impulse response to the identified international supply of credit.<sup>22</sup> The size of the shock is one-standard deviation of the leverage residuals, which is equal to 7.5% per quarter on average across all countries (e.g., leverage going from 10 to 10.075). We censor the responses included in the computation of the mean group estimator at the 10% level (5% each side) to eliminate the possible influence of any outliers. The dark and light shaded areas represent the one- and two-standard deviation confidence intervals, respectively, computed scaling the variance of the country responses across countries, which provides a consistent estimate of the true cross section mean impulse response.

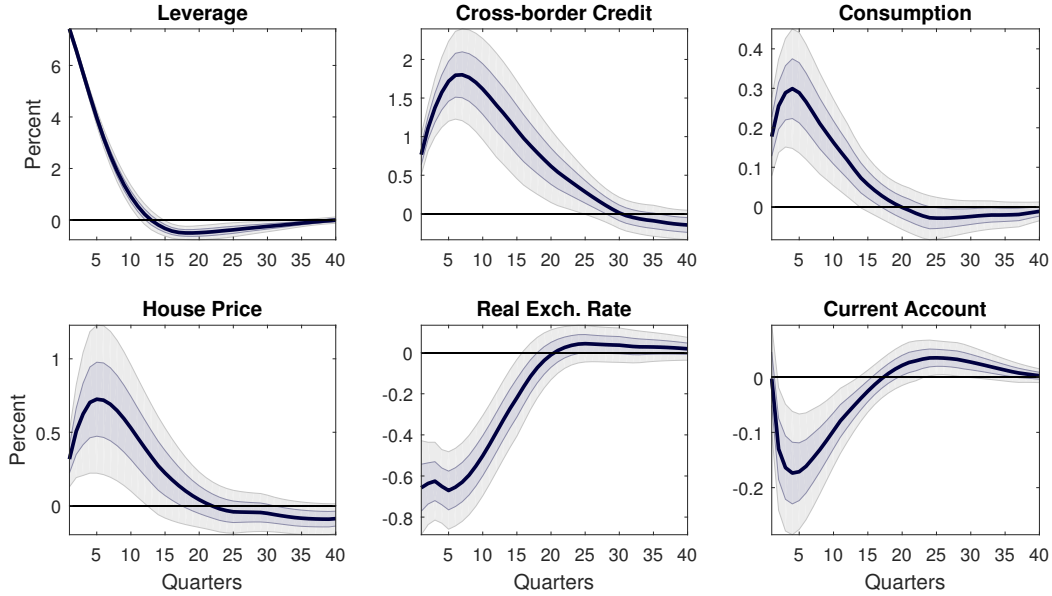
The estimated impulse responses are consistent with the transmission in our theoretical model. In the typical small open economy (represented here by the average response in the cross-section) the leverage shock leads to a statistically significant and persistent increase in cross-border claims, real consumption, and house prices; to a real exchange rate appreciation, and a deterioration of the current account balance.<sup>23</sup> These responses are in accordance with the behavior of a constrained economy in our model whereby house prices respond to increased demand for collateral following the credit shock. The responses are also consistent with the the exchange rate collateral and the endowment valuation effects dominating the (contractionary) debt valuation effect of the appreciation. Therefore, both the exchange rate appreciation and the

---

<sup>22</sup>We use a simple average of the country-specific estimates to construct the mean-group estimates. Results are robust to using a weighted average because of the large number of countries in the sample.

<sup>23</sup>Note here that these are conditional responses to a particular shock. In the data, the current account balance should add up to zero globally only unconditionally (and ignoring the global discrepancy), but not conditional on particular shocks. Even unconditionally, the current account does not add up to zero globally if scaled relative to country GDP.

**Figure 6.** IMPULSE RESPONSES TO AN INTERNATIONAL CREDIT SUPPLY SHOCK



NOTE. Mean group estimate of the impulse responses to a one standard deviation (7.5%) increase in the leverage of US Broker-Dealers. The dark and light shaded areas are one- and two-standard deviation confidence intervals, respectively.

house price increase possibly amplify the initial effect of the shock.

Note also that, like in our model, in the medium term (about 4-5 years after the shock) the exchange rate goes through a period of depreciation, before reverting completely to its long-run value. The depreciation is associated with falling consumption and house prices, and a current account surplus. The amplitude of the bust-phase, however, is much smaller than the boom-phase, even though it has the same duration. In contrast, in the theoretical model (and the episodes reported in Figure 1), the two phases have not only similar duration, but also comparable amplitude.

Quarterly data on interest rates on loans, either in domestic or foreign currency, are not available for a large and long panel data set like ours. The model, however, helps us connect the response of house prices to these interest rates. For simplicity, assume the LTV parameter  $\theta$  is equal to one. The first order conditions for credit (14)

and house prices (16) can be combined to give:

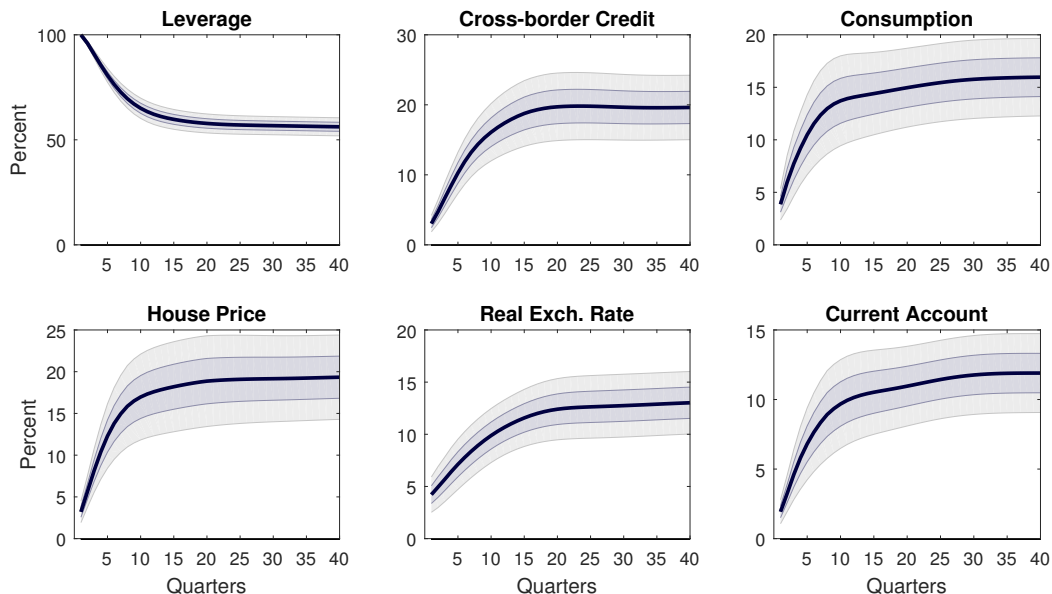
$$\beta R^b = \frac{\kappa}{q} \quad \text{and} \quad \beta R \frac{s_2}{s_1} = \frac{\kappa}{q}.$$

These two expressions equalize the cost of borrowing, in domestic and foreign currency, respectively, to the return on housing. Housing returns in domestic currency must fall in line with declining lending rates when the international supply of credit expands. Given a constant marginal utility of housing, this adjustment must happen via an increase in house prices that erodes returns as the boom triggered by the shock propagates.

The model, therefore, predicts that returns on other “risky” assets fall in response to the international credit supply shock like in [Blanchard et al. \(2015\)](#). In our context, credit is the “international asset” while housing is the “domestic non-financial asset.” A positive international credit supply shock appreciates the real exchange rate and decreases the return on housing via an asset price boom. In the data, the net effect of capital inflows will depend on the balance between the falling returns in local currency and the appreciating real exchange rate that make those lower returns more attractive to foreign investors. The fact that, in the data, the current account swings into deficit in response to the shock means that cross-border claims co-move closely with total net capital inflows. This observation in turn suggests that the exchange rate component of the total return may be dominating the underlying return decline in domestic-currency from the perspective of foreign investors.

The effects of the international credit supply shock are quantitatively sizable. Cross-border bank claims display a hump-shaped response, with an impact response of slightly less than 1% percent and a peak response just below 2% percent. This corresponds to an impact increase of about 250 billions USD if this multiplier is applied to all countries in the sample, relative to the post global financial crisis global average of 25 trillions USD. Consumption and real house prices increase by about 0.3% percent and 0.75% percent, respectively, above their long-run levels within a year. The real exchange rate vis-a-vis the US Dollar appreciates on impact by about 0.6% percent, arguably driven by the nominal exchange rate, strengthens some more, and then reverts very slowly toward its equilibrium level. Finally, the current account turns into a deficit, with a trough of more than 0.15% percentage points of GDP. Ignoring the fact that the VAR model responses may not be accurate to evaluate a large change in leverage,

**Figure 7.** SHARE OF VARIANCE EXPLAINED BY INTERNATIONAL CREDIT SUPPLY SHOCK.



NOTE. Mean group estimate of the forecast error variance decomposition due to the international credit supply shock. The dark and light shaded areas are one- and two-standard deviation confidence intervals, respectively.

the estimated elasticities imply a consumption drop during the global financial crisis of about 4-5 percentage points in the typical economy, compared to the 7 percent registered by the United States during the NBER-dated phase of the Great Recession, with leverage falling by 15 times.

Figure 7 reports the mean group estimate of the share of variance explained by the international credit supply shock. The shock we focus on is important for the dynamics of the data as it explains a sizable portion of the variance of all variables in the VAR system. At the same time, US Broker-Dealers' leverage is explained mostly by shocks to itself within the first a year or so, consistent with the identification assumptions made. Our leverage shock accounts for about fifteen to twenty percent of the long-run forecast error variance of cross-border credit, house prices, and consumption, and a slightly smaller share (but still above 10%) for the real exchange rate and the current account. These magnitudes exceed the share of forecast error variance that is typically explained by domestic monetary policy shocks.

As we report in the paper supplement, these results are fairly robust. We have findings similar to the baseline when we condition on contemporaneous world GDP in the VAR systems. When we exclude lagged country variables from the leverage equation, we find stronger effects, while the effects of the shock are qualitatively similar, but quantitatively a bit weaker when we condition on world equity prices, possibly reflecting the fact that world equity prices incorporate information, like risk premia, also captured by the leverage variable.<sup>24</sup> When we drop from the sample Japan, Germany, the United Kingdom, and Switzerland—economies that are relatively large in economic or financial terms like the United States—we find exactly the same results. Finally, when we estimate the model with averages of Local Projections (Jorda, 2005), constructed like our mean group estimates, we find essentially the same results for all variables except the exchange rate for the forecast step 3, 4 and 5. And even in the case of the exchange rate response, the results are essentially the same with Local Projections if we use the real effective exchange rate, rather than the bilateral rate vis-a-vis the US dollar, which is less volatile.

## 5 Understanding Cross-Country Differences

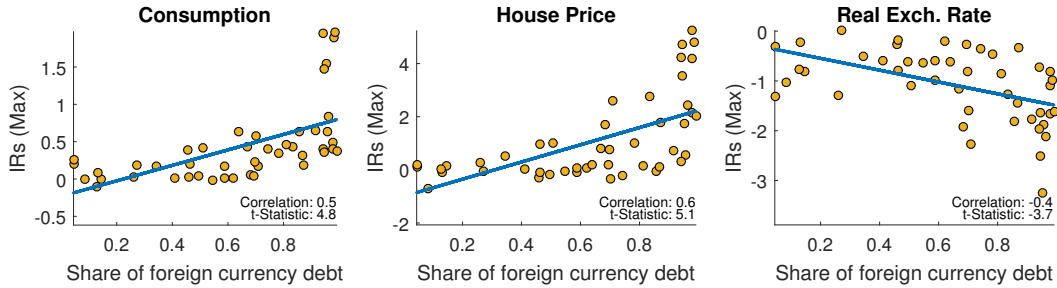
The error bands in Figure 6 for the responses of consumption, house prices, and the real exchange rate are relatively wide, reflecting significant differences across countries. In this section, we investigate whether this heterogeneity follows specific patterns.

We conjecture that the observed cross-country differences are associated with the interaction between the amplification that asset prices generate in response to an international credit supply shock and certain features of the economies in our sample. In particular, our model suggests that the intensity of the country responses to the credit shocks may be affected by the share of foreign currency liabilities and the maximum LTV limit prevailing in that country.

---

<sup>24</sup>The reason why these additional controls do not alter the results significantly is that the reduced form residuals of the country VARs are weakly correlated across countries. For example, in the case of the consumption equation, the average pairwise correlation across countries of the reduced form innovations is a mere 0.075 in the baseline. Conditioning on world equity prices, it falls only to 0.06.

**Figure 8.** CROSS-COUNTRY DIFFERENCES IN RESPONSE TO INTERNATIONAL CREDIT SUPPLY SHOCK: SHARE OF FOREIGN CURRENCY LIABILITIES.



NOTE. The three panels plot the peak impulse response of consumption (left panel), house prices (middle panel) and the real exchange rate (right panel) to the international credit supply shock (vertical axis,  $IRs (Max)$ ) against the share of foreign currency liabilities (horizontal axis,  $1/(1 + \eta)$ ). An exchange rate increase is a depreciation. See the Data Appendix on data sources and definitions.

## 5.1 Share of foreign currency credit

As the share of foreign currency debt increases, the collateral exchange rate effect of a binding borrowing constraint becomes stronger. A higher share of foreign currency debt, however, also strengthens the debt valuation effect that, all else equal, is contractionary. The endowment valuation effect instead is unaffected by this country characteristic in the model.

Country differences in the share of foreign currency liabilities can account for two additional expansionary effects in the model. First, a higher share of foreign currency denominated debt decreases the interest rate burden of debt as global financial intermediaries transfer a smaller cost of hedging onto domestic borrowers. Second, a higher share of foreign currency denominated debt increases the sensitivity of the real exchange rate to variations in the level of credit via the demand channel in equation (27).

Figure 8 provides evidence consistent with our conjecture. The figure plots the cross-country peak responses of consumption (left panel), house prices (middle panel), and the real exchange rate (right panel) against the share of foreign currency liabilities ( $1/(1 + \eta)$ , horizontal axis). The correlations are particularly strong for consumption

and house prices (about 0.5 and 0.6, respectively), and just slightly weaker ( $-0.4$ ), but clearly still statistically significant, also for the real exchange rate.

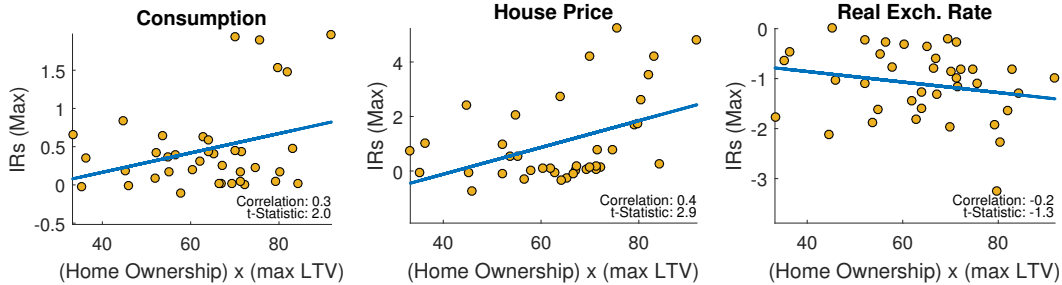
In general, it is not possible to characterize analytically the sign of the net effect associated with a higher share of foreign currency denominated debt in the model. However, in the numerical example discussed in Figure 4, the combination of the effects above implies that consumption, house prices, and the real exchange rate are more sensitive to international credit supply shocks the higher the share of debt denominated in Foreign currency. Therefore, we interpret the empirical correlations in Figure 8 as supportive evidence that the expansionary effects discussed in the model dominate. Of course, in the data, other channels that are absent from our model may be at work. One example is the traditional expenditure switching effect of the exchange rate, which would normally be contractionary, but it is muted in our model because of the absence of production. Another force often discussed in the literature is the wealth effect of any non-zero net foreign asset position. In spite of the possible mitigating effects of these channels, we believe the scatter plots in Figure 8 provide strong evidence in support of the idea that a higher share of foreign currency debt amplifies the expansionary effect of international credit supply shocks.

## 5.2 Maximum LTV

A second candidate explanatory variable for the heterogeneous sensitivity to the international credit supply shock is country variation in the LTV ratio, which is a key determinant of leverage in the domestic financial system. For given asset prices, if the borrowing constraint is binding, a higher maximum LTV ratio allows domestic households to obtain additional credit, which contributes to push up house prices, further relaxing the borrowing constraint. The model predicts that, as long as the borrowing constraint is binding, higher LTV ratios will lead to larger increases in consumption and house prices, and a more pronounced appreciation of the real exchange rate.

Figure 9 plots the peak impulse responses of consumption (left panel), house prices (middle panel), and the real exchange rate (right panel) from the VAR (vertical axis) against the maximum LTV ratio interacted with the home-ownership rate (horizontal axis). We weight the LTV ratio with the home-ownership rate to capture both leverage in the local financial system and the availability of housing collateral. Indeed, with high

**Figure 9.** CROSS-COUNTRY DIFFERENCES IN RESPONSE TO INTERNATIONAL CREDIT SUPPLY SHOCK: LTV RATIOS.



NOTE. The three panels plot the peak impulse response to the global liquidity shock (vertical axis,  $IRs (max)$ ) of consumption (left panel), house prices (middle panel) and the real exchange rate (right panel) against the maximum LTV weighted by the homeownership ratio (horizontal axis,  $Home\ Ownership \times max\ LTV$ ). Data Appendix on data sources and definitions.

leverage but a low home-ownership rate, like in the case of Germany and Switzerland for instance, the economy's sensitivity to a credit shock should be lower according to our model.<sup>25</sup>

Figure 9 is consistent with the mechanism stressed in our model. In this case, the correlation is economically and statistically significant for house prices (about 0.4) and consumption (about 0.3), but weaker (about  $-0.2$ ) and not statistically significant for the real exchange rate. From the perspective of the model, an upward-sloping association between the LTV ratio and the house price response, like the one found in the data, implies that the marginal household is credit-constrained in most countries. This conclusion supports the assumption we made in deriving the transmission of the shock.

## 6 Robustness

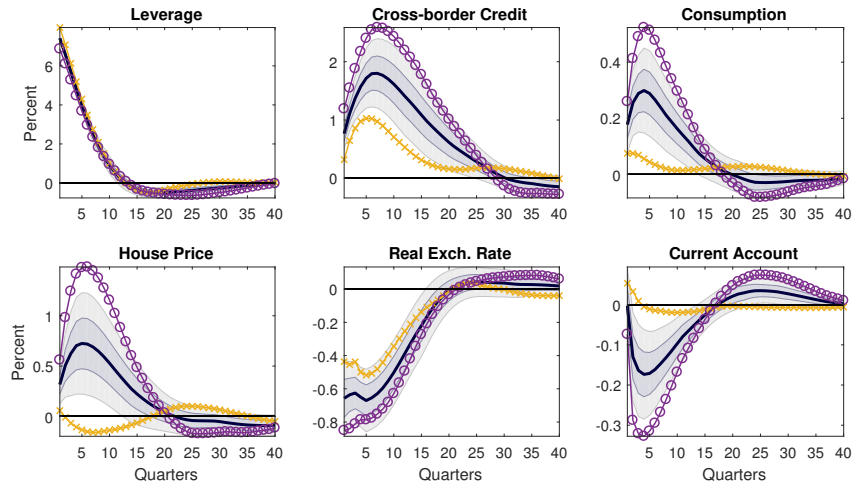
The results reported in Figure 8 and 9 are robust to using the average response over the first 4 quarters, or the share of variance of these variables explained by the credit

<sup>25</sup>High home-ownership alone may be a reflection of pervasive cash transactions and an inflation-hedging demand for housing, which are elements beyond the scope of our model.

supply shock during the first year.<sup>26</sup>

An alternative way of looking at the heterogeneity in the effects of the international credit supply shock is to estimate our panel VAR model on different groups of countries, or ‘bins’, based on ex-ante country characteristics. Given the large number of countries, we can split the sample in two, while preserving the consistency of the mean group estimates. We create these two sub-samples of 25 countries by grouping ‘above’ or ‘below’ the median value of each characteristic (labeled ‘high’ and ‘low’), and recomputing the mean group estimates within the subsample.

**Figure 10.** IMPULSE RESPONSES: HIGH AND LOW SHARE OF FOREIGN CURRENCY LIABILITIES

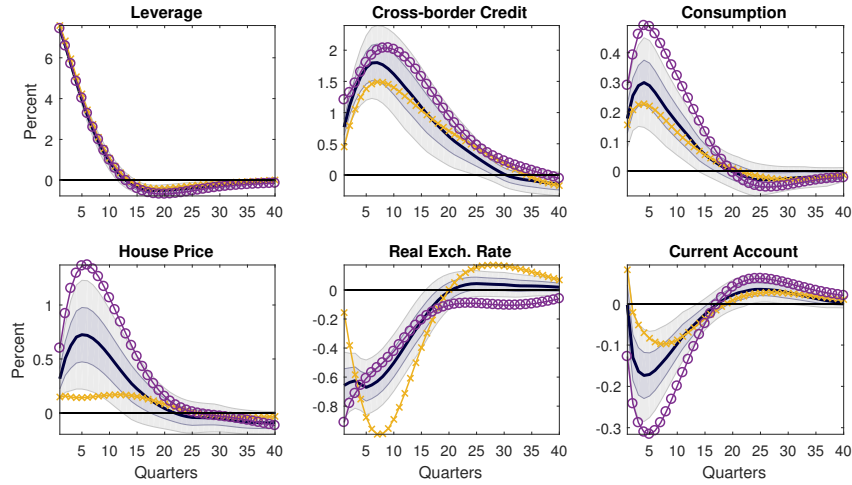


NOTE. Mean group impulse responses to a one standard deviation (7.5%) increase in the leverage of US Broker-Dealers. The dark and light shaded areas are the one and two standard deviation confidence intervals, respectively. The solid line with crosses and circles plot the mean group estimate for ‘Low’ and ‘High’ share of foreign currency liabilities, respectively.

Figure 10 and 11 report the results for the max LTV limit weighted by home ownership and the share of foreign currency liabilities, respectively. Each Figure plots the baseline impulse responses to the leverage shock, together with the mean (sub)group estimate for the ‘low’ (solid line with crosses) and ‘high’ (solid line with circles) value of the characteristics.

<sup>26</sup>These robustness exercises, although not reported here, are available on request.

**Figure 11.** IMPULSE RESPONSES: HIGH AND LOW MAXIMUM LTV



NOTE. Mean group impulse responses to a one standard deviation (7.5%) increase in the leverage of US Broker-Dealers. The dark and light shaded areas are the one and two standard deviation confidence intervals, respectively. The solid line with crosses and circles represents the mean group estimate for ‘Low’ and ‘High’ maximum LTV (weighted by Home ownership), respectively.

As we can see, the results for the share of foreign currency liabilities and the max LTV limit give the same message conveyed by the scatter plots in Figure 8 and 9. Notice here that a lower share of foreign currency liabilities is associated with a much smoother response than with a lower maximum LTV limit, with consumption and the current account almost flat in the former case.

## 6.1 Alternative Interpretations of Cross-Country Heterogeneity

The intensity of the country responses to the international credit supply shock seems to be closely associated with the share of foreign currency liabilities ( $1/(1 + \eta)$ ) and the maximum LTV limit ( $\theta$ ). We focused on these two characteristics because of their clear counterpart in the model, which helps interpreting the mechanisms at work. But other characteristics also be important.

Table 3 reports the correlation between the cross-country peak responses of consumption, house prices, and the real exchange rate and a small set of additional country

**Table 3.** CROSS-COUNTRY DIFFERENCES IN THE INCIDENCE OF THE INTERNATIONAL CREDIT SUPPLY SHOCK: ALTERNATIVE INTERPRETATIONS.

	Consumption	House Price	Exch. Rate
Max Loan to Value	0.32	0.44	-0.21
Foreign currency liability	0.53	0.54	-0.39
Exch. Rate flexibility	-0.40	-0.41	0.16
Capital controls (inflows)	0.23	0.32	-0.28
Mortgage debt / GDP	-0.31	-0.42	0.25

NOTE. Correlation between the peak impulse response of selected variables (columns) and country characteristics (rows). See the appendix on data definition and sources.

characteristics, including a measure of exchange rate flexibility (from the annual fine classification of [Ilzetzi et al. \(2010\)](#), averaged over the 2000-2010 period), a ‘*de iure*’ measure of controls on capital inflows (from [Fernandez et al. \(2016\)](#), averaged over the 1995-2013 period), and the mortgage credit over GDP (from [Warnock and Warnock \(2008\)](#), averaged over the 2001-2005 period).

Higher exchange rate flexibility is associated with a lower consumption and house price response to the international credit supply shock, in line with the notion that a flexible exchange rate can help absorb external shocks. The result is even starker in Figure S.8 in the supplement, where we plot the impulse response by sub-groups of ‘low’ and ‘high’ exchange rate flexibility countries, and find that more flexible regimes are less vulnerable to the shock.

The table also shows that controls on capital inflows correlate positively with the incidence of the shock, possibly suggesting that more vulnerable countries may adopt more controls on inflows. Notice however that the share of foreign currency liabilities and the tightness of capital controls on inflows are strongly correlated with each other (0.56). Thus, the positive correlation between capital controls and the consumption response might be picking up the correlation between the consumption response and the share of foreign currency liabilities.

Finally, mortgage debt over GDP is negatively associated with the consumption responses. However, without the aid of a model, assessing whether this correlation reflects better domestic risk sharing opportunities associated with a more developed financial system or other less intuitive mechanisms is a difficult task that we leave for

future research.

## 7 Conclusions

A positive international credit supply shock generates a boom in macroeconomic quantities and asset prices for receiving economies.

This paper illustrates the mechanism of transmission in a simple model of collateralized borrowing in domestic and foreign currency with international financial intermediation. Consistent with this model, we identify international credit supply shocks empirically in a panel VAR framework, and document the tight connection between the theory and the data. Identified international credit supply shocks trigger a consumption boom, house price inflation, and real exchange rate appreciation, as well as a current account deterioration. These shocks also explain a significant share of the variance of these variables.

The macroeconomic and financial consequences of international credit supply shocks are quantitatively stronger the higher the share of foreign currency liabilities in total liabilities and the maximum LTV limit in the domestic credit market. Other country characteristics might be associated with this heterogeneity, including the flexibility of the exchange rate regime. We leave a detailed exploration of the role of the exchange rate regime in explaining the countries differences that we uncovered for future research.

## References

- AIZENMAN, J. AND Y. JINJARAK (2009): “Current account patterns and national real estate markets,” *Journal of Urban Economics*, 66, 75–89.
- ALMEIDA, H., M. CAMPELLO, AND C. LIU (2006): “The Financial Accelerator: Evidence from International Housing Markets,” *Review of Finance*, 10, 321–352.
- BASKAYA, Y., J. DI GIOVANNI, S. KALEMLI-OZCAN, AND M. ULU (2017): “International Spillovers and Local Credit Cycles,” Tech. rep., NBER Working Paper 23149.
- BEKAERT, G., M. HOEROVA, AND M. LO DUCA (2013): “Risk, uncertainty and monetary policy,” *Journal of Monetary Economics, Elsevier*, 60, 771–788.
- BERGER, D., V. GUERRIERI, G. LORENZONI, AND J. VAVRA (2015): “House Prices and Consumer Spending,” NBER Working Papers 21667, National Bureau of Economic Research, Inc.
- BLANCHARD, O., J. D. OSTRY, A. R. GHOSH, AND M. CHAMON (2015): “Are Capital Inflows Expansionary or Contractionary? Theory, Policy Implications, and Some Evidence,” NBER Working Papers 21619, National Bureau of Economic Research, Inc.
- BOZ, E. AND E. G. MENDOZA (2014): “Financial innovation, the discovery of risk, and the U.S. credit crisis,” *Journal of Monetary Economics*, 62, 1–22.
- BRÄUNING, F. AND V. IVASHINA (2016): “Monetary Policy and Global Banking,” Working paper.
- BRUNNERMEIER, M. AND Y. SANNIKOV (2014): “A Macroeconomic Model with a Financial Sector,” *American Economic Review*, 104, 379–421.
- BRUNO, V. AND H. S. SHIN (2015): “Cross-Border Banking and Global Liquidity,” *Review of Economic Studies*, 82, 535–564.
- CALVO, G. A., L. LEIDERMAN, AND C. M. REINHART (1996): “Inflows of Capital to Developing Countries in the 1990s,” *Journal of Economic Perspectives*, 10, 123–139.
- CALZA, A., T. MONACELLI, AND L. STRACCA (2013): “Housing Finance And Monetary Policy,” *Journal of the European Economic Association*, 11, 101–122.
- CERUTTI, E. M., J. DAGHER, AND G. DELL’ARICCIA (2015): “Housing Finance and Real-Estate Booms; A Cross-Country Perspective,” IMF Staff Discussion Notes 15/12, International Monetary Fund.

- CESA-BIANCHI, A., L. F. CESPEDAS, AND A. REBUCCI (2015): “Global Liquidity, House Prices, and the Macroeconomy: Evidence from Advanced and Emerging Economies,” *Journal of Money, Credit and Banking*, 47, 301–335.
- CHARI, A., K. D. STEDMAN, AND C. LUNDBLAD (2017): “Taper Tantrums: QE, its Aftermath and Emerging Market Capital Flows,” NBER Working Papers 23474, National Bureau of Economic Research, Inc.
- CHARI, V., P. J. KEHOE, AND E. R. MCGRATTAN (2005): “Sudden Stops and Output Drops,” *American Economic Review*, 95, 381–387.
- FAVILUKIS, J., S. C. LUDVIGSON, AND S. VAN NIEUWERBURGH (2017): “The Macroeconomic Effects of Housing Wealth, Housing Finance, and Limited Risk-Sharing in General Equilibrium,” *Journal of Political Economy*, forthcoming, -, -.
- FERNANDEZ, A., M. W. KLEIN, A. REBUCCI, M. SCHINDLER, AND M. URIBE (2016): “Capital Control Measures: A New Dataset,” *IMF Economic Review*, 64, 548–574.
- FERRERO, A. (2015): “House Price Booms, Current Account Deficits, and Low Interest Rates,” *Journal of Money, Credit and Banking*, 47, 261–293.
- FORBES, K., D. REINHARDT, AND T. WIELADEK (2016): “The Spillovers, Interactions, and (Un)Intended Consequences of Monetary and Regulatory Policies,” NBER Working Papers 22307, National Bureau of Economic Research, Inc.
- GABAIX, X. AND M. MAGGIORI (2014): “International Liquidity and Exchange Rate Dynamics,” NBER Working Papers 19854, National Bureau of Economic Research, Inc.
- GALI, J. AND T. MONACELLI (2005): “Monetary Policy and Exchange Rate Volatility in a Small Open Economy,” *Review of Economic Studies*, 72, 707–734.
- GETE, P. (2009): “Housing Markets and Current Account Dynamics,” MPRA Paper 20957, University Library of Munich, Germany.
- GOURINCHAS, P.-O., R. VALDES, AND O. LANDERRETICHE (2001): “Lending Booms: Latin America and the World,” *Economia*, 1, 47–100.
- HE, Z. AND A. KRISHNAMURTHY (2013): “Intermediary Asset Pricing,” *American Economic Review*, 103, 732–770.
- ILZETZKI, E., C. M. REINHART, AND K. S. ROGOFF (2010): “Exchange Arrangements Entering the 21st Century: Which Anchor Will Hold?” Unpublished manuscript.

- JAPPELLI, T. AND M. PAGANO (1989): “Consumption and Capital Market Imperfections: An International Comparison,” *American Economic Review*, 79, 1088–1105.
- JERMANN, U. AND V. QUADRINI (2012): “Macroeconomic Effects of Financial Shocks,” *American Economic Review*, 102, 238–71.
- JORDA, O. (2005): “Estimation and Inference of Impulse Responses by Local Projections,” *American Economic Review*, 95, 161–182.
- JUSTINIANO, A., G. E. PRIMICERI, AND A. TAMBALOTTI (2015): “Credit Supply and the Housing Boom,” NBER Working Papers 20874, National Bureau of Economic Research, Inc.
- KAPLAN, G., K. MITMAN, AND G. L. VIOLANTE (2016): “Non-durable Consumption and Housing Net Worth in the Great Recession: Evidence from Easily Accessible Data,” NBER Working Papers 22232, National Bureau of Economic Research, Inc.
- KIYOTAKI, N. AND J. MOORE (1997): “Credit Cycles,” *Journal of Political Economy*, 105, 211–48.
- LANE, P. R. AND J. C. SHAMBAUGH (2010): “Financial Exchange Rates and International Currency Exposures,” *American Economic Review*, 100, 518–540.
- MENDOZA, E. G. AND M. E. TERRONES (2008): “An Anatomy Of Credit Booms: Evidence From Macro Aggregates And Micro Data,” NBER Working Papers 14049, National Bureau of Economic Research, Inc.
- MERTENS, K. AND M. O. RAVN (2013): “The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States,” *American Economic Review*, 103, 1212–47.
- MIAN, A., A. SUFI, AND E. VERNER (2016): “Household Debt and Business Cycles Worldwide,” Unpublished, Princeton University.
- PESARAN, M. H. AND R. SMITH (1995): “Estimating long-run relationships from dynamic heterogeneous panels,” *Journal of Econometrics*, 68, 79–113.
- PESARAN, M. H., R. SMITH, AND K. IM (1996): “Dynamic Linear Models for Heterogenous Panels,” in *The Econometrics of Panel Data*, ed. by L. Mtys and P. Sevestre, Kluwer Academic Publishers, Dordrecht, The Netherlands, chap. 8, 145–195.
- REY, H. (2013): “Dilemma not trilemma: the global cycle and monetary policy independence,” *Proceedings - Economic Policy Symposium - Jackson Hole*, -, 1–2.

- (2016): “International Channels of Transmission of Monetary Policy and the Mundellian Trilemma,” *IMF Economic Review*, 64, 6–35.
- ROMER, C. D. AND D. H. ROMER (2004): “A New Measure of Monetary Shocks: Derivation and Implications,” *American Economic Review*, 94, 1055–1084.
- SALOMAO, J. AND L. VARELA (2017): “Exchange Rate Exposure and Firm Dynamics,” Working Paper.
- SIMS, C. A., J. H. STOCK, AND M. W. WATSON (1990): “Inference in Linear Time Series Models with Some Unit Roots,” *Econometrica*, 58, 113–44.
- STOCK, J. AND M. WATSON (2012): “Disentangling the Channels of the 2007-2009 Recession,” *Brookings Papers on Economic Activity*, Spring, 81–135.
- SUTHERLAND, A. (2005): “Incomplete pass-through and the welfare effects of exchange rate variability,” *Journal of International Economics*, 65, 375–399.
- WARNOCK, V. C. AND F. E. WARNOCK (2008): “Markets and housing finance,” *Journal of Housing Economics*, 17, 239–251.

# A Appendix: Episodes of Boom-Bust in Capital Flows

In this appendix we document the behavior of asset prices and the real economy associated with episodes of boom-bust in international capital flows in a large sample of advanced and emerging markets as reported in Figure 1 in the introduction. We focus on a specific component of capital flows, namely BIS reporting banks' cross-border claims to all sectors of the receiving economy (i.e. financial and non-financial) as this is the measure of international credit that we use in our empirical analysis in the paper.<sup>27</sup> For example, if  $KF_{ij,t}$  is cross-border bank claims from country  $j$  to country  $i$  in period  $t$ , our capital flows variable for country  $i$  is defined as:

$$KF_{it} = \sum_{j=1}^N KF_{ij,t} \quad \forall j \neq i, \quad (\text{A.1})$$

where  $j = 1, \dots, N$  indexes the aggregate of all BIS reporting banks in country  $j$ .

We consider a slightly wider set of variables than those studied in the theoretical model and in the VAR analysis: GDP, private consumption, short-term interest rates, house prices and equity prices, the effective exchange rate, the exchange rate vis-a-vis the US Dollar, and the current account as a share of GDP. All variables are expressed in real terms. The sample period runs from 1970 to 2012 and the frequency is annual (while in our VAR analysis we use quarterly data). We use annual data to work with the longest time series available. A description of the variables and their sources is reported in the appendix below.

We focus on the behavior of asset prices and the real economy around boom-bust episodes in cross-border claims. To identify boom-bust episodes we define a boom (bust) as a period of at least three years, in which annual cross-border claim growth is positive (negative).<sup>28</sup> The peak (trough) is defined as the last period within the

---

<sup>27</sup>Consistent with the empirical analysis, in the model, a representative household sector borrows directly from international financial intermediaries.

<sup>28</sup>This procedure is similar to the one used in the literature, e.g., [Gourinchas et al. \(2001\)](#), [Mendoza and Terrones \(2008\)](#). The literature typically defines these episodes as periods in which credit (or capital inflows) rise more than one-standard deviation above trend level. Our results are robust to using the traditional approach. The advantage of our approach is that we do not need to detrend

**Table A.1.** SUMMARY STATISTICS OF BOOM-BUST EPISODES.

<b>ALL</b>	Number	Duration	Max	Min	Amplitude
booms	2.4	7.3	32.6	5.0	131.6
busts	1.4	4.4	-4.2	-20.4	-53.2
boom-bust	0.9	12.7	36.3	-21.8	103.5
<b>AE</b>	Number	Duration	Max	Min	Amplitude
booms	2.5	8.8	28.5	3.7	130.1
busts	1.1	3.7	-4.6	-17.5	-36.9
boom-bust	0.8	13.4	29.5	-19.2	115.7
<b>EM</b>	Number	Duration	Max	Min	Amplitude
booms	2.3	6.1	35.9	5.9	132.8
busts	1.6	4.8	-4.1	-21.9	-61.3
boom-bust	0.9	12.4	40.5	-23.5	96.0

NOTE. Summary statistics of boom-bust episodes computed over the full sample of countries (ALL), and splitting the sample in advanced (AE) and emerging economies (EM).

episode in which the annual rate of growth of cross-border credit is positive (negative). We define “boom-bust” those episodes in which a bust follows a boom.

This procedure identifies 134 booms, 81 busts, and 50 boom-bust episodes. Figure 1 in the paper reports the results. The summary statistics for these episodes (such as duration and amplitude) are reported in Table A.1. Note that, of the 50 boom-busts, only 20 started after 1994 and about 33 ended by 2005; in the case of the booms, 76 started by 1994 and 83 ended by 2004. Thus, these statistics suggest that the bulk of the episodes identified are not concentrated in the run up to, or during, the global financial crisis.

---

the data or pick a threshold for the amplitude, which introduces spurious variation over time in the analysis.

## B Appendix: Data Sources

We consider 57 countries in our empirical analysis: 24 advanced economies (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, and US) and 33 emerging economies (Argentina, Brazil, Bulgaria, Chile, China, Colombia, Croatia, Czech Republic, Estonia, Hong Kong, Hungary, India, Indonesia, Israel, Korea, Latvia, Lithuania, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, Serbia, Singapore, Slovakia, Slovenia, South Africa, Taiwan, Thailand, Ukraine, and Uruguay). The data set includes the period 1970:Q1 – 2012:Q4 (subject to availability) for the following variables:

**Total cross-border bank lending.** Foreign claims (all instruments, in all currencies) of all BIS reporting banks vis-à-vis all sectors deflated by US consumer price inflation. Source: BIS.

**Cross-border bank credit.** Foreign claims (loans and deposits, in all currencies) of all BIS reporting banks vis-à-vis the banking sector deflated by US consumer price inflation. Source: BIS.

**House prices.** Nominal house prices deflated by consumer price inflation. Source: OECD house price database, BIS Residential property price statistics, Dallas FED International House Price Database, National Central Banks, National Statistical Offices, academic and policy publications. More details on the definitions and the sources are reported in Table [B.1](#).

**Equity prices.** Equity price index deflated by consumer price inflation. Source: OECD, IMF IFS, Bloomberg.

**Nominal exchange rate vis-à-vis US dollar.** US dollars per unit of domestic currency (a decline is an appreciation). Source: Datastream. Real bilateral exchange rate obtained by adjusting with CPI indexes.

**Real effective exchange rate.** Index such that a decline is an appreciation. Source: IMF IFS, BIS, Bloomberg.

**GDP.** Real index. Source: OECD, IMF IFS, Bloomberg.

**Consumption.** Real private final consumption index. Source: OECD, IMF, IFS, Bloomberg.

**Consumer prices.** Consumer price index. Source: OECD, IMF IFS, Bloomberg.

**Short-term interest rates.** Short-term nominal market rates. A real ex-post interest rate is obtained by subtracting consumer price inflation. Source: OECD, IMF, IFS, Bloomberg.

**Current account to GDP ratio.** Current account balance divided by nominal GDP. Source: OECD, IMF IFS, Bloomberg.

**Home-ownership.** Average over the 2005-2014 period. Source: Housing Finance Information Network (HOFINET).

**Maximum LTV ratios.** For the vast majority of countries, the maximum LTV corresponds to its legal limit (when such limit exists). Source: [Cerutti et al. \(2015\)](#).

**Shares of foreign currency liabilities over total liabilities.** Authors' calculations based on a confidential version of the *Total cross-border bank lending* data described above. The share is computed as cross-border bank claims in foreign currency over total cross-border bank claims. The correlation between these shares and those of [Lane and Shambaugh \(2010\)](#) is 0.78. Source: BIS.

**Table B.1. HOUSE PRICE DATA: DEFINITIONS AND SOURCES**

Country	Definition	Source
Argentina	House Apartments in Buenos Aires City, average price per sqm (USD).	Arklems
Australia	House Price Indexes: Eight Capital Cities.	OECD
Austria	Residential property prices, new and existing dwellings.	OECD
Belgium	Residential property prices, existing dwellings, whole country.	OECD
Brazil	Residential Real Estate Collateral Value Index.	Central Bank
Bulgaria	Residential property price, existing flats (big cities), per sqm.	BIS
Canada	Average existing home prices.	OECD
Chile	HPI general, houses and apartments.	Central Bank
China	House price index.	OECD
Colombia	House Price Index.	Central Bank
Croatia	House price index	Dallas FED
Czech Rep.	Residential property prices, existing dwellings, whole country.	OECD
Denmark	Price index for sales of property.	OECD
Estonia	Residential property prices, all dwellings, per sqm.	BIS
Finland	Prices of dwellings.	OECD
France	Indice trimestriel des prix des logements anciens.	OECD
Germany	Residential property prices in Germany.	OECD
Greece	Prices of dwellings.	OECD
Hong Kong	Residential property price, all dwellings, per sqm.	BIS
Hungary	Residential property price, all dwellings, per sqm.	BIS
Iceland	Residential property price, all dwellings (Reykjavk), per sqm.	BIS
India	Residex.	National Housing Bank
Indonesia	Residential property prices, new houses (big cities), per dwelling.	BIS
Ireland	Residential property price index.	OECD
Israel	Prices of dwellings.	OECD
Italy	Residential property prices, existing dwellings, whole country.	OECD
Japan	Urban Land Price Index.	OECD
Korea	House price index.	Dallas FED
Latvia	Residential property prices, new and existing flats, whole country.	ECB
Lithuania	Residential property price, all dwellings, per sqm.	BIS
Luxembourg	House price index.	Dallas FED
Malaysia	Residential property prices, all dwellings, per sqm.	BIS
Malta	Property Prices Index (based on advertised prices).	Central Bank
Mexico	Residential property prices, all dwellings, per dwelling.	BIS
Morocco	Residential property prices, existing dwellings, per sqm.	BIS
Netherlands	House Price Index for existing own homes.	OECD
New Zealand	House price index.	OECD
Norway	House price index.	OECD
Peru	Residential property prices, per sqm.	BIS
Philippines	Residential and commercial property prices, flats (Makati), per sqm.	BIS
Poland	Residential property prices, (big cities), per sqm.	BIS
Portugal	Residential property prices, new and existing dwellings.	BIS
Russia	Residential property prices, existing dwellings, per sqm.	BIS
Serbia	Average prices of dwellings in new construction, per sqm.	National Stat. Office
Singapore	Average prices of dwellings in new construction, per sqm.	BIS
Slovak Rep.	Residential property prices, existing dwellings.	OECD
Slovenia	House price index.	OECD
South Africa	Residential property price.	BIS
Spain	Precio medio del m2 de la vivienda libre (> 2 anos de antiguedad).	OECD
Sweden	Real estate price index for one and two dwelling buildings for permanent living.	OECD
Switzerland	Real estate price indices.	OECD
Taiwan	National House Price Index.	Synyi
Thailand	Residential property prices, average of all detached houses, per sqm.	BIS
Ukraine	Average Price of Apartments, Kiev, per sqm (USD).	Blagovest
UK	Mix-adjusted house price index.	OECD
US	Purchase and all-transactions indices.	OECD
Uruguay	Precio promedio del metro cuadrado de compraventas, Montevideo (USD).	National Stat. Office

**Note.** See Cesa-Bianchi, Cespedes, and Rebucci (2015) for more details and the sources of house price series extended with historical data.